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AN INTEGRATED APPROACH TO THE MANAGEMENT OF PRODUCTION AND MARKETING RISKS IN THE PRIMARY SECTOR OF THE DEVELOPING COUNTRIES

study by
Olivier Matringe
UNCTAD associate expert

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INTRODUCTION

1. The international trade in commodities represents 23 per cent of all world trade. Commodities account for about 34 per cent of the export earnings of the developing countries; in the case of Africa, the figure is 79 per cent.

2. It is a notorious fact that the commodity producer receives only a tiny percentage of the price paid by the final consumer; a major proportion of the value of the product is taken up by transport, processing and distribution costs and other administrative and commercial expenses. This study will focus on the commercial costs connected with the various risks that can be observed all the way along the chain; a category which embraces all the costs directly or indirectly connected with the commercial risks, i.e. expenses linked with the collection of data, logistic policy, insurance, financing and the risk premiums entailed in the marketing of commodities. In the developing countries, the commercial costs relating to the primary sector are heavier than those in the other economic sectors. Commercial expenses are high because the risks are considerable and high risk levels produce an increase in costs in every link of the chain. This factual situation not only has an impact on the competitiveness of the developing countries but also on the prices ultimately paid to the producers and thus on the social position of the weakest economic agents.

3. With the appearance of the new international economic order based on the principles of globalization, the developing countries must realize that political and financial stability, a climate of confidence and the reliability of counterparties are the keystones of commercial prosperity and, consequently, of the overall development of the economy. These factors are, unfortunately, endangered by the many risks that may be encountered all along the chain. These countries which, as we mentioned above, are still highly dependent on commodities, are all the more exposed to the risks infecting trade in that the framework conditions and infrastructure are distinctly below the standard of those found in the industrialized countries. Government authorities and the economic agents of the private sector have, however, the power to change this situation , though not overnight, by becoming aware of the effects of such and such a risk on trade and development, of the importance of the decisions they make and of the means and instruments available to manage these risks and improve the efficiency of trade.

4. When the economic agents decide to market their products, they are often unaware of the number and nature of the risks to which they are going to be exposed. There are, in fact, a vast number of hazards to be considered ranging from geological and environmental risks and the risk of natural disasters as well as political, social, commercial, financial, legal and guarantee-commission risks and the risks of fire, theft and deterioration of the goods to problems of information security, transport, stock-management, prices, exchange rates, interest rates, quality deterioration, violation of employees' rights, accidents, injuries and the like. Some of these are more injurious than others; once the risks have been identified, the degree of importance of each of them must be assessed together with ways and means of managing the most hazardous.

5. Risk management in commodity trade is, in fact, an operation of identifying the various risks endogenous and exogenous to the production and marketing of primary commodities and, in particular, consideration of ways and means of eliminating them or at very least reducing them to a lesser, and thus sustainable, level. In view of the fact that commercial hazards can appear at any stage of the nexus, risk management must be present at the levels of planning, organizing,

supervising, coordinating and monitoring the various activities undertaken to establish an effective ex ante loss plan which would minimize the potential losses of an economic agent.

6. Management of the risks linked to the activities of the primary sector is not only a factor affecting trade and production but also a necessity, an element essential to the survival of the traders. This is all the more true in the developing countries in that their economies often depend on a few commodities and that a good understanding of the risks and of ways of handling them will have a direct impact on the conditions in which the economic agents will be able to sell their products, obtain credits, finance projects on advantageous terms and, consequently, expand. To encourage development and growth, the various producers and exporters, but also the government authorities, must become aware of the many hazards connected with the production or trade operations and their effects on the microeconomic and macroeconomic balance of their countries.

7. The fact of not being protected against the risks inherent in the production and marketing of commodities produces a whole series of effects which can be lethal for the trader concerned and for the economy in general. Quite apart from the very real danger of bankruptcy, if the economic agents have not been able to assess the significance of the situation, they will be obliged to waste precious time in handling unexpected losses and trying to resolve hopelessly entangled problems which affect their solvency, their profits and the growth of the company, cooperative or country. In short, their trading situation is likely to deteriorate sharply and they will thus have enormous difficulties in finding trustworthy counterparties, capital to develop projects or financing for their continued operations. This state of affairs is all the more heavy with consequences in that, in the new economic environment, these firms are, for the most part, not yet known and must "prove themselves". Nowadays they have the advantage of being able to establish trade relations with some serious counterparties but, to do so, they have to manage their risks effectively so as to avoid being classed as unstable firms or countries.

8. Risk-management operations are generally recognized as founded on four basic principles:

✓ Systematic and ongoing investigation of the exposure to risks;

✓ Evaluation of the nature of the risks, their probability, their ramifications and their impact on the firm under consideration;

✓ Planning and organizing an appropriate risk-monitoring system and identifying techniques and instruments calculated to minimize the potential losses inherent in the risks concerned; and

✓ Applying, calculating the cost of and following up these techniques together with the necessary external coordination and cooperation (e.g. with financial risk specialists, insurance experts, government authorities, banks, etc.).

9. Appropriate action to reduce the aforesaid risks in the developing countries will have an impact not only on their growth potential and trading capacity but also on the social level of the economic agents by contributing , for instance, to the eradication of poverty. As this study will endeavour to illustrate, UNCTAD, the international organization whose mandate with respect to commodity questions is primordial, has the capacity to play a significant role, the more so as it already possesses certain programmes concerned with the reduction of the risks linked with operations in the primary sector.

10. We shall analyse in this study the main families of risks that may be encountered along the commercial nexus - from production to importation through the determining export stage. Chapter I will focus on the domestic trading risks, i. e. the hazards that can occur between D-Day, when the decision to produce is taken, and the moment when the goods enter the international sphere. Chapter II will examine the risks linked to exporting, i. e. the introduction of the products to the international market. Chapter III will deal with the risks involved in the shipment of the goods to the importing country. Lastly, on the basis of the preceding analyses, conclusions will be drawn making it possible to identify specific actions to support the developing countries in their endeavours to reduce the risks connected with the production and marketing of primary commodities.

I. DOMESTIC TRADING RISKS

A. Introduction

11. The economic agents who purchase primary commodities on the local market to process and/or market them, and ultimately export them, are exposed to various trading risks. This chapter will examine more particularly the agricultural sector. In the mining and metallurgical sectors, the economic agent often combines the roles of producer and exporter, with the result that some "domestic" risks will then be if not abolished at least much reduced. The same is generally true of the oil sector.

12. What is more, agriculture, unlike the industrial sector, has always been a relatively high-risk activity from the very fact that it depends on many exogenous variables. Although the variation in agricultural productivity depends partly on human initiative as regards the adoption of production techniques and the inputs used, it also depends very much on uncontrollable factors such as climate, the quality of the land, diseases, etc. From prehistory until modern times, men have tried to limit the various production risks by, for instance, having recourse to crop rotation, diversification, cultivation in alternating rows, the use of robust but low-yield varieties or even different ploughing methods. These risks are more closely linked with production techniques and are relatively well-known. Consequently, they will not be the subject of this study.

13. However, there are still a number of residual hazards. They are, moreover, of considerable importance and, if they cannot be eliminated, there are techniques for at least managing them. It is essential to control the risks connected with the quantitative uncertainty associated with the production of certain primary commodities. A bad harvest in the developing countries will not only give rise to a loss of export earnings but also, and this is perhaps still more important, to a deterioration in the trading relations between the economic agents and, quite possibly, even an impairment of the country's image. Virtually the whole of this study will be based on the various risks that the agents in the commercial nexus are likely to encounter and their impact on the development of trade - the constancy of trading relations and the reliability of the counterparty being the two axioms essential to any sustainable development both at the microeconomic level and at the more overall country level.

B. Production risks

14. Before reaping the fruit of his labours, the producer has to wait. He has begun his activities but he does not know whether the crop will be able to ripen without any hindrance. As we emphasized above, he is faced with some significant residual risks which can destroy his production. Among these dangers we may mention the climatic risks (hurricanes, cyclones, tornadoes, typhoons, hailstorms, frosts, drought, lightning, etc.), natural disasters (earth tremors, avalanches, landslides, volcanic eruptions, etc.), pathological disorders (diseases, fungi, parasites, insects, animals, etc.) and other unexpected hazards such as banditry.

15. The damage caused can result in immeasurable harm.[1] That is why the firms concerned must seek ways and means of transferring the risks most likely to affect them. Agricultural insurance, and more particularly crop insurance, can be a vehicle for doing so that is worth consideration. There are, in fact, two main families of crop insurance schemes, the first guaranteeing specific risks (heading by heading) and the second multi-risk. Generally speaking, agricultural insurance is an important aspect of commodity risk management. A brief description of the problems arising in the developing countries will be attempted below (see box 1).

Box 1

THE CASE OF MAURITIUS

An important mechanism which has greatly helped to support sugar cane production has been the Sugar Insurance Fund Board which insures against cyclones and drought. To a considerable extent, it has protected the sugar cane producers against climatic risks. This "guarantee":, which is compulsory for the producers, is managed by a separate organization on which are represented the government authorities, the producers and the processing industries. The insurance takes into account the specific risks connected with the damage that can be caused by hurricanes (relatively frequent in that country), fires, heavy rainfall, yellow-spot disease and drought. The premiums payable and the reimbursement in the event of a claim are calculated on the basis of pre-established formulas. In the particular case of fire insurance, a premium of about six rupees per ton of insurable sugar cane must be paid (corresponding on average to about 0.09 per cent of the price paid to small producers); sharecroppers and landowners contributing in proportion to the area cultivated. When a fire occurs, these firms are reimbursed on a basis of 250 rupees per ton (the processor will also receive 79 rupees). In general, when a natural disaster occurs, the producers are reimbursed to the extent of 60-65 per cent of their losses. This insurance has proved useful and has been efficiently managed. Even though the situation in Mauritius is rather special, this example demonstrates that an insurance based on formal articles, a product and a precise geographical area, can be viable and promote the development of a sector. Moreover, the system established is relatively flexible since, when the Fund's reserves are sufficiently large, the premiums payable can be reduced. In general, the poor development of the insurance market in the developing countries arises from the fact that the premiums, even if they must be calculated so as to cover potential damage, are often too high and those in most need of insurance cannot afford it.

16. Agricultural insurance is very usually lacking in the rural areas of developing countries. Where it exists, this budding industry is more particularly concentrated in the towns. In the event of bad harvests or bad weather, the purchasers are exposed to production risks and then find themselves in a critical situation when they are required to fulfil pre-established trading agreements. Producers are thus considered to be high-risk counterparties.

17. Agricultural insurance lacks a foundation in the mass of producers since it is not within the reach of the low-income classes which are engaged in the agricultural sector. One of the main problems encountered is low productivity and the fact that the small producers are often below the threshold of insurability.

18. Consequently, it is by no means surprising to find that most of the insurance schemes that exist in the developing countries are managed by parastatal institutions which offer a general coverage to their members. What is more, they are sometimes even regarded as an instrument of government policy. However, with the appearance of liberalization currents and the fact that certain producers are seeking specific types of coverage, the private sector will be completely free to seize the opportunity of undertaking certain activities in this area.

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[1] It might be interesting to quote here an example relating to oil production. In the North Sea, it is not rare to suffer losses of a million United States dollars, as was the case of the 1989 explosion suffered by the Philips Petroleum company. The need to insure such activities is thus self-evident.

19. The companies would be able to try offering or extending certain types of coverage of crop insurance , on a modest and limited scale to begin with . As experience is accumulated, the infrastructure is put in place and promotion methods become more assured, they could propose more general and complex forms of protection.

Table 1

Overview of some of the crop-insurance schemes available in developing countries

Country	Products concerned	Description of insurance scheme
Chile	Fruit, cereals and rapeseeds	Voluntary, provided by a private company
Cyprus	Cereals, citrus and other fruits, grapes, forage crops and potatoes	Compulsory, administered by a parastatal organization
Dominican Republic	Rice, beans, maize, sorghum, coffee, cacao, onions, garlic, tomatoes, bananas, watermelons, cotton, pineapples, tobacco, yucca, potatoes and oranges	Linked to credit and administered by a parastatal organization
India	Rice (paddy), wheat, coarse grains, pulses and oilseeds and, to some extent, grapes, citrus fruits, bananas, pomegranates, sugar cane, rubber, eucalyptus and poplars	Linked to credit and administered by a parastatal organization
Mauritius	Sugar cane (possibly tea and tobacco also)	Linked to credit and compulsory
Philippines	Rice, wheat and tobacco	Compulsory for those seeking credit from banks, administered by a parastatal organization
Sri Lanka	Rice (paddy) and, to a certain extent, green gram, cowpeas, soya beans, maize, betel, rubber, cotton, tobacco, sugar cane, tea, pineapples, passion fruit, ginger, chillies, gherkins, potatoes, onions, flowers and medicinal herbs	Administered by the Agricultural Insurance Board
Venezuela	Cereals, sugar cane, coffee, vegetables, fruits, roots and tubers, oilseeds and fibre crops	Administered by a State agency
Windward Islands	Bananas	Compulsory, administered by the WINCROP company
Zambia	Maize, soya beans, cotton, sunflower, groundnuts, sorghum, barley and wheat	Voluntary, administered by a State agency
Zimbabwe	Mainly tobacco and wheat	Voluntary and individual, administered by private companies

Source: UNCTAD secretariat (UNCTAD/SDD/INS/1)

20. Crop insurance has always attracted interest and is the major component of agricultural insurance. Although important, however, it is not the only form of insurance to contribute to the development of the rural sector, others such as those relating to agricultural machinery, warehousing, processing of the raw materials by the producers, agricultural liability and even life

insurance[2] have also a major role to play. An interesting example is that of guarantees against the mistakes and anomalies that are the responsibility of seed suppliers; some producers can now insure against financial losses arising from an input problem.

21. A few insurance companies have already developed outside the public sector and have devised some modest covers for small producers. The development of insurance systems cannot in itself constitute a panacea for the problems of the rural sector. However, activities undertaken with companies supplying production factors, combined with efforts to improve the dissemination of agricultural data, can greatly strengthen the progress of the primary sector in the developing countries.

22. Insurers should also seek to establish contacts with other agents such as cooperatives, trade societies and other vocational associations. In respect of promotion, for instance, fairs and agricultural exhibitions are ideal places for introducing the various insurance policies. Agricultural insurance can also lend itself to a more intense regional cooperation among developing countries.

23. As in the case of the operations to calculate the profitability of a project or an investment, agents desirous of developing agricultural insurance should study the markets on a medium- and long-term basis. A well-designed agricultural insurance programme has a strong potential, even if it has to be subsidized a bit in its initial stage: a crop-insurance scheme may become an instrument of national policy (to encourage crop specialization) and help to alleviate poverty in the rural areas.

24. It is important to note here that the local insurance companies, whether public or private, must pass on a portion of the risks insured to agents capable of bearing them. Reinsurance (on the local market and on the international markets) is consequentially essential. Reinsurers are, however, sometimes far from enthusiastic about the idea of guaranteeing certain risks in the developing countries. Nevertheless, some European reinsurance companies have been present in that market for a number of years. In addition, there are some original solutions that are worthy of consideration. The United States market, for instance, has produced an interesting system. Since December 1992, the Chicago Board of Trade (CBOT)[3] has been negotiating some financial instruments (futures contracts and, since 1995, options[4]) relating to insurance contracts that cover natural disasters. The aim is to pass the inherent risks on to the market by offering the possibility to United States insurers of covering themselves and obtaining reinsurance at a lower cost.

25. Lastly, collaboration with the rural credit establishments is one of the best ways for insurers to develop their business. To increase productivity and obtain access to more advanced technology, farmers need loans to acquire the production factors and technical equipment essential for the cultivation of primary commodities meeting certain quality standards. The banking sector is at the heart of the system since it usually supplies the financing needed for production and , when a loan is accompanied by a compulsory coverage clause, renders possible an association between the producers and the insurance companies. The establishment of agricultural-insurance systems also

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[2] Some financial agencies require that a life-insurance policy be taken out before they will grant a loan.

[3] Like MATIF (Marché à terme international de France), the CBOT is a commodity exchange on which commodity futures contracts and options are negotiated. See, on that subject, "A survey of commodity risk management instruments" (UNCTAD/COM/15/Rev.1), of December 1994.

[4] On 19 September 1995, the CBOT launched nine new option contracts: one national contract, five regional contracts and three state contracts (California, Texas and Florida).

makes it possible for banks to secure themselves against systemic risks (natural disasters) which would affect a large proportion of their portfolios and could reduce them to insolvency.

Box 2

UNCTAD AND THE INSURANCE FIELD

At the thirteenth session of the Committee on Invisibles and Financing Related to Trade in 1990, the UNCTAD secretariat was given a mandate "to prepare a study on the possibilities for increasing insurance awareness in developing countries and in particular for extending insurance cover to productive entities in the traditional sector, with particular reference to agricultural production, by devising appropriate insurance covers and taking into account the work done in other organizations".

At the eighth session of the Conference, it was decided to establish a Standing Committee dealing with insurance which was "to analyse prospects for developing and strengthening the insurance sector and enhancing the trade of developing countries in this sector." Studies were thus undertaken by UNCTAD to examine "linkages between insurance schemes, rural credit systems and development strategy in this sector, including the role of cooperatives."

The work of this Standing Committee and the UNCTAD studies culminated in some practical attempts (particularly in Africa) to establish agricultural insurance systems. A workshop was held at Mombasa in November 1996 at the end of which the establishment of a technical assistance project was recommended.

C. Risks associated with producer-financing operations

26. Notwithstanding the importance of the aforesaid problem, the quantitative risks properly so-called are unfortunately not the only sources of danger that can be observed. Like the nineteenth-century English farmers observed by Sismondi, the small producers from the developing countries are tending to enter a market logic and, consequently, the monetary economy. To remain competitive in an open economy, they must improve their productivity and, to do so, resort to capital investment. The more they invest, however, the more vulnerable they become. Even without any aspirations to expand, the producers have to finance, over and above their own incomes, the agricultural inputs (seeds, pesticides, fertilizers, etc.), machinery and equipment.

27. The farmers thus need credit, but financing is difficult to obtain in the developing countries, the more so since the producers are considered to be bad risks. Obtaining production loans will be that much easier where there is not very much uncertainty concerning the economic agent in question. The fact of having a crop-insurance policy, for example, may tip the scales when a loan is applied for. Although it may be a prerequisite, however, it is frequently not sufficient in itself.

28. Other strategies to guarantee a loan are often needed. What is more, the poor liquidity of the local markets tends to aggravate the problem. One of the keys to resolving some of these difficulties would be recourse to the financing available on the international market. But there again, even more than before, serious guarantees must be offered to the potential counterparties.

29. Before the harvest, when the crops are not yet available, it is relatively difficult to offer accepted forms of security. The danger here lies in the fact that, in developing countries which do not possess trustworthy registration systems, the future harvest may be used as security several times over. There are, nevertheless, strategies that can be employed such as resort to documentary credits forming the subject of specific arrangements which take into account the needs and requirements of both the producers and the lending institutions. We might mention here the back-to-back credit system whereby the farmer receives a documentary credit from a local exporting (or trading) firm, which is itself in possession of a documentary credit issued by a foreign importer or purchaser. The second credit is backed by the first and can serve as a guarantee. The use of certain procedures based on countertrade can also constitute an interesting way of financing inputs. In Viet

Nam, for example, certain foreign trading companies supply seeds (and fertilizers, etc.) and calculate their repayment in terms of the future harvest.

30. When the producer already possesses some or all of the harvested crop, recourse to warehousing and to certain methods based on the use of commodities as collateral (negotiable warehouse warrants) can greatly improve the conditions of the developing countries. This system is all the more interesting in that it can be used by small firms which do not have enough financial resources to make use of other more expensive techniques. What is more, the potential creditors will be aware of the fact that such techniques supply a reliable guarantee in that the commodities are no longer in the hands of the producer/borrower: the counterpart risk is thus eliminated[5].This method can also be used by the processing industries, trading companies and exporters, as we shall see in the next chapter.

31. There are other risks hampering the efficient functioning of the trade in commodities at the local level. Although they are many and varied, the principal ones are those connected with disputes regarding the quantity expected, a failure to respect quality requirements, delivery delays, etc.

D. Non-delivery or partial delivery risks

32. A trading firm that commits itself by a contract with a producer runs risks: a risk of non-delivery if it is simultaneously linked to a purchasing customer, a risk linked to the product quotation if the prices to be paid to the producer have already been fixed and a credit risk if the farmer has already received a payment on account.

33. Trading firms, which are essentially middlemen, often deal in parallel with a producer and a buyer. A failure to pay in the production area will inevitably have repercussions on the firm itself and thus a recursive effect all the way along the commercial nexus.

34. As we have previously emphasized, the producer requires inputs if he is to be able to grow his produce. He has thus to obtain some funds even before the crop is available. The trading firms often supply the necessary loans. A commercial relationship based on trust will consequently be initiated and a failure to deliver will damage a number of commercial agents to a far from negligible extent.

35. Once the crop has been harvested, the producer can also fail to meet his contractual obligations. Indeed, one of the primordial factors that can influence non-delivery at this stage is a rise in the price of the product concerned. If a predetermined price has been agreed upon with the trading firm and the rates increase considerably, the producer will be tempted to sell his produce to another agent at the new market price. Nevertheless, if a farmer deludes himself into making a short-term gain, his reputation will be tarnished and he will have enormous difficulty in disposing of his goods and obtaining financing in the future. A short-term gain may, in fact, involve heavy losses if the situation is examined in the long-term perspective.

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[5] See, on this subject, the UNCTAD report on collateralized commodity financing (UNCTAD/COM/84).

Box 3

USE OF THE THIRD-PARTY HOLDING METHOD OR WAREHOUSE RECEIPTS (RECEIPT-WARRANTS OR COLLATERAL CERTIFICATES) IN THE DEVELOPING COUNTRIES [a/]

Warehouse receipts, used as collateral warrants, are negotiable instruments issued on primary commodities. The various commercial agents (mainly producers and processors, but also trading firms, exporters, etc.) active in the primary commodities sector have the possibility of converting their stocks (which are often regarded as a constraint since they tie up capital) into negotiable instruments. The adoption of such techniques improves marketing since these receipts can be sold, exchanged, used as guarantees for a loan, taken up in a commercial letter of credit or even used to set off an open forward position (when a delivery is notified).

The producers thus have the benefit of an instrument that will enable them to extend the selling period beyond the harvest date and obtain what is often a better price. On assigning his production to a warehouse in good standing, the farmer receives a warehouse receipt that can be used as a guarantee to obtain a short-term a loan on favourable conditions. Like the producers, the processing plants have also the possibility of pre-financing their activities. Structured operations based on a system of warehouse warrants will be recognized by the commercial banks and will supply a much appreciated security, since they make access to international credits possible. What is more, exporters of and dealers in primary commodities who possess a certificate of third-party holding will also be able to obtain foreign-currency financing at close to market rates (i.e. at a lower rate of interest) and thus be covered against exchange risks (since the repayment of the debt and the export earnings will be expressed in the same currency). In practice, this type of technique is used, for example, in Kenya and Uganda, where coffee stocks are often used as guarantees to obtain prefinancing (in sterling), in Malaysia for pepper and in the Philippines for sugar.

The use of warehouse certificates can distinctly improve the terms of trade. Since potential buyers/creditors no longer need to see or, necessarily, take possession of the products, more flexibility occurs. In parallel, the fall in the level of risk will produce an increase in the volumes traded and a reduction in transaction costs. The use of these techniques will also have the advantage of contributing to the development (or strengthening) of the spot markets and forward markets. Operations will no longer be restricted to the storage and inspection places alone. Over-the-counter transactions or transactions on an organized market will thus become possible. If they give rise to delivery of the products at a later date, the underlying conditions will be there for the development of a forward market and even in some circumstances (very exceptional incidentally) of a commodity exchange (in South Africa, for instance, certain warehouses are linked to the SAFEX futures market).

It is important to emphasize here that the use of warehouse receipts combined with a hedging operation will help to strengthen the quality of the guarantee since the value of the stock will be securitized. Banks will be ready to advance 80 to 90 per cent of the value of the transaction if they have the benefit of a "covered receipt", whereas they will grant only 50 to 60 per cent in its absence. The example of the ZEP bank may be quoted. This institution has adopted a system known as a guaranteed price contract. It is an agreement, initially proposed to the associations of small producers, processors, dealers and exporters of eight East African countries, which makes it possible to prefinance the coffee and cotton commercial nexuses at unbeatable rates. This operation is possible because it is based on warehouse certificates covered by means of options. In Kenya, for instance, the ZEP bank finances the coffee exporters and receives collateral certificates in return; it also offers them a put option (purchased on the Liffe/LCE) which guarantees them a minimum price for their coffee stocks. This operation summarizes in fact the detailed functioning of the guaranteed price contract. The African Export-Import Bank (AFREXIMBANK), which is also active in a number of African countries, offers over and above this system a special risk-management programme which includes a guarantee against political and sovereign risks.

[a/] See, on this subject: "Collateralized commodity financing, with special reference to the use of warehouse receipts" (UNCTAD/COM/84) of July 1996 and Richard Lacroix and Panos Varangis, "Using warehouse receipts in developing and transition economies", Finance and Development, September 1996.

Box 3 (contd.)

Although very widespread in the industrialized countries, this kind of strategy is not often used in the developing ones b/, mainly because of the absence of the appropriate structural and institutional frameworks. Among the various obstacles that may be enumerated, the two main ones are an unsuitable institutional, legal and judicial environment and the inexperience of the commercial agents - especially the local banks. The legal framework should clarify the concept of a commercial security and recognize warehouse receipts as collateral certificates. In addition, the inspection of primary commodities, to guarantee the equivalence of the physical quality and that expressed in the certificate, must be feasible. A whole series of precise criteria must thus be introduced for the development of systems based on third-party holding to take place. The advantages are many and the barriers hindering their use are not insuperable. It is true that a number of reforms must be adopted and that minor decisions can to some extent counteract the efforts made.

Nevertheless, experience shows that the possibility exists and that a number of countries (e.g. Poland) have been able to create the conditions to exploit the possibilities offered to them in this area. It would be a pity if other countries do not take advantage of them!

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b/ A number of them have, however, had recourse to techniques of this kind - such as India, Mali (since 1987/88), Mexico and South Africa, or have established a system which operates correctly such as, for instance, Indonesia and Ghana (which began a pilot project for maize in 1993). Other countries, such as Poland, Romania or Uganda have already undertaken legal and structural reforms to adopt a commercial system including third-party holding.

36. Non-delivery and credit risks are both counterpart risks (price risks will be discussed later). If the producer actually delivers the goods, there no problem. If not, the trading firm will suffer a loss. In the developing countries, these risks are relatively high and depend on three factors :

- The absence of standard and trustworthy agricultural insurance schemes : when the harvest is inadequate and the producer cannot meet his commitments (make delivery), his commercial partner will often have no recourse in the absence of a reliable insurance scheme;

- The limited weight of the banking system and an archaic, or even non-existent, financial structure: in the developed countries, notes of hand can be negotiated with banks; firms have also the possibility of resorting to specialized factoring houses (see box 4 below). Alternatively, for major contracts, the trading firms can require a performance guarantee issued by a specialized organization or warehouse. Unfortunately, such possibilities are seldom used in the developing countries since they are little known to the economic agents; and

- An underdeveloped legal system, which increases the difficulty of signing contracts with trustworthy business partners, or makes it difficult to have recourse to collateral security (land or crops).

Box 4

FACTORING

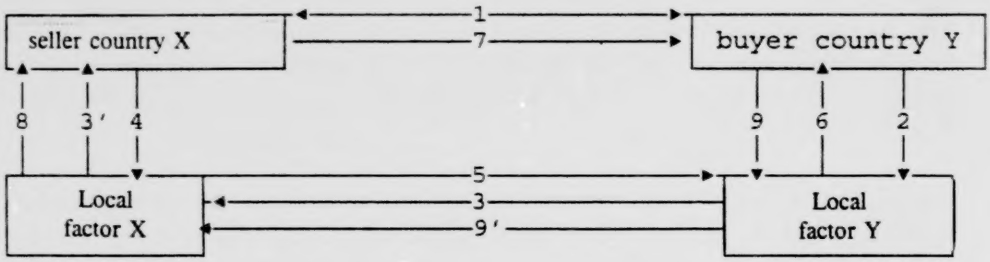
The Bank of France defines factoring as "a transfer of commercial debt from a holder to a "factor" who undertakes to collect it and to guarantee its performance, even in the case of temporary or permanent default by the debtor." Factoring is thus a financing and intermediation method of guarding against the risk of insolvency. The term "factoring" covers services which can be used either separately or in combination - evaluation of the creditworthiness of the purchaser - intermediation against the risk of insolvency - collection services - management of "customers" accounts - coverage of the non-payment risk - total or partial financing of customers' receivables. One of the advantages of factoring is that it enables the exporter to offer terms of payment on open account to buyers who are approved by the factoring company.

The exporter makes his commercial debt over to a local factor who advances him funds against presentation of the invoices. This factor, in his turn, transfers the debt to an opposite number in the buyer's country, who assumes the insolvency risk and takes responsibility for collection. The import factor collects on the invoices and remits the funds, less his commission, to the export factor.

Forfaiting: This form of factoring is used to finance exports, particularly of equipment, to the developing countries. The exporter delivers the goods against receipt of bills of exchange or promissory notes issued by the importer. The exporter then discounts this paper to a forfaiting factor who keeps it until the due date or else sells it on the unofficial secondary market. Forfaiting has the dual advantage of having reasonable interest rates and making it possible to reinsure against political and documentary risks as well as transfer and insolvency risks.

Double factoring : Another possible structure is double factoring which combines the functions of an export factor and an import factor, using standardized terms. Much used in the developed countries (the turnover of the factoring companies is estimated at more than 200 billion dollars), it is based on two international networks: Factors Chain International and International Factor Group.

Diagrammatic example of a factoring process in prefinancing



(1) Trading contract
(2) Request for customer's approval
(3) and (3') Request for guarantees
(4) Guarantees
(5) Agreement
(6) Approval
(7) Shipment of goods accompanied by the invoice specifying that payment must be made to the factoring company
(8) Payment in cash at the request of the exporter or payment on maturity
(9) Payment of the factor (by the buyer)

E. Physical risks

37. When a trading firm has taken possession of the product, it becomes responsible for transporting and preserving it. This economic agent is thus faced with transport and storage risks. The problem is aggravated in the developing countries by the absence of adequate transport networks, of trustworthy storage structures and of insurance against deterioration of the product and against theft.

38. The transport risk usually occurs between the place of production and the spot in which the trading firm is located. In most developing countries, the infrastructure is hardly favourable to transport and often archaic means are sources of additional hazards (see chapter III for fuller information).

39. The risks are aggravated still further by the pilfering and other potential forms of theft that can arise during the journey. What is more, if goods are stolen, claims against the carrier are complicated and do not necessarily lead to systematic compensation. A number of trading firms are, however, situated close to the production point, thus reducing the transport time and, consequently, the probability of such events occurring.

40. Risks of theft or pilfering also exist when the trading firm decides to store the products but, at that stage, it is possible to establish a system of guarantees or insurance schemes. In fact, the problem seems less critical from the very fact that the goods are in the custody of the firm itself.

41. Other risks of significant extent appear when storage operations are considered, namely, those relating to the deterioration of the primary commodities, which are often perishable foodstuffs, and to the movements of commodity prices. The quality of the produce is very important and it is essential that it should be maintained throughout the storage process. The trading firms and other business enterprises (even in some cases producers' associations) must have access, then, to appropriate structures or else should consider the possibility of leasing recognized warehouses. They could then take advantage of the fact to resort to the modern financing methods described in box 3.

42. The major factor underlying the management of stocks of goods is the value assigned to them. The basic element is the price used to determine this value. A fall in prices will have an impact on the overall value of the stocks. If the forms of hedging that exist are not used, major price variations will inevitably lead to the bankruptcy of many trading firms since they will often have to sell, at a later date, produce below the price they had paid to the producers. In view of the great instability of primary commodity quotations, these firms will be disinclined to hold stocks. There are, however, strategies for managing price risks which can not only greatly improve the situation of the various economic agents in the nexus but also encourage their flexibility.

F. Price risks

43. The price risk, one of the most hazardous snags that appear anywhere along the commercial nexus, derives from the fact that purchasing (or contracting) operations and sales operations are out of phase.

44. In the production phase, the period between the decision to produce, and consequently invest, and the harvest can be comparatively long. The initial financing calculation should, according to all economic logic, take into account the anticipated receipts, but future flows are

uncertain, since they depend on unstable prices. By definition, storage operations are non-synchronous, on account of the time lag between the collection of the produce and its consumption. As we have emphasized, many commercial transactions are based on forward operations, mainly for the purpose of ensuring a market (short sales[6]) or, if the mirror effect of forward purchases is taken into account, of ensuring the availability of the produce.

45. In most developing countries, it is the State which used to control the domestic collection, prices, quality and marketing of the main agricultural products. Prices were either regulated directly or fixed by parastatal organizations (stabilization funds or marketing boards) which had been set up for the purpose. National stabilization systems administered domestic prices and endeavoured to neutralize the pernicious effects of the fluctuation in the prices of primary commodities. However, a number of these programmes, whose effectiveness was not questioned in the 1970s, were based on assumptions (regarding price and exchange rates) which, in the 1980s, proved to be far removed from reality. The ongoing slump in the prices of the primary commodities has completely changed the situation and the public sector no longer acts to stabilize but only to support prices. However that may be, in both cases the State used to assume the bulk of the price risks.

46. Since the end of the 1980s, the various currents of liberalization and structural adjustments have radically transformed the systems governing the domestic and foreign marketing of primary commodities in many developing countries. Governments thus tend to encourage the rise of the private sector, which is playing a role of increasing importance. Such transformations have, incidentally, been significant in many African and South American countries. Since the gradual dismantling of the stabilization funds, farmers receive a high proportion of the ultimate price of their produce but, on the other hand, are no longer protected against the instability of prices on the world market. The various economic agents in the nexus are also confronted with the same difficulties and, with no experience in that area, they often do not know how to manage price risks.[7] The question thus arises whether the transfer of the risk from the State to the commercial firms of the private sector has been matched by any endowment of these agents with the means of taking precautions against such hazards!

47. We think it relevant at this stage to take a few simple examples of standard trading transactions in the absence of risk-management instruments.

48. First of all, let us consider the case of storage of stocks. Consumption of most agricultural produce is spread over the year, whereas production is fixed in time. If the market is efficient, the function of some economic agents will be to store the produce to ensure a balance between supply and demand. Storage operations have, however, the dual disadvantage of locking up liquid assets and exposing the agent in question to a price risk. Indeed, the probability should not be underestimated that this agent will be unable to sell his produce except at a price distinctly lower than the cost price or, in the case of a producer, that the current price will be lower than that he would have been able to receive if he had sold immediately (in the case of overproduction, prices may even be lower than production costs). Consequently, in the absence of hedging strategies, the

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[6] A short position means an excess of sales over purchases. For instance, a firm which holds 40 batches of cacao but which has committed itself to sell 60 in three months' time is 20 batches short.

[7] "Government policies affecting coffee export marketing" (UNCTAD/COM/MISC.55/Add.1, vol. 2), of November 1993.

economic agents will reduce their seasonal stocks to the bare minimum. Such behaviour, rational in itself, will increase rigidity and thus help to increase the volatility of primary commodity prices.

49. Let us now consider the processing stage. One of the characteristic features of processing enterprises is the tightness of their margins. Since inputs represent in general 90 to 95 per cent of the post-processing price, the net profit is only between 1 and 2 per cent. The potential gain from these industries is often so small that the slightest variation in prices, between the purchase of the raw material and the obtaining of the "finished product", can result in a clear loss. When the great volatility of commodity prices is taken into account, it is quite easy to see the magnitude of the problem.

50. Lastly, in the absence of risk-management instruments, the banking sector (and other financial agents) is reluctant to finance traders with cash-flow problems. Like local trading firms, agricultural cooperatives can be very much affected by the instability of prices, the more so in that the credit standing (proportion of own capital) of these entities is relatively slight. The smallest change in prices can thus have a catastrophic impact on their financial reserves and even result in bankruptcy. The banks will thus hesitate to grant loans to local merchants (and producers) operating in the primary sector, particularly those which do not use any hedging. Since financing is essential for any operation of this kind, these obstacles will substantially hinder the effective functioning of the nexus.

51. Once the price risks and the "affected" economic agent have been identified, there are strategies which, if they cannot eliminate them, can at least manage them effectively. Resort to organized futures markets or to over-the-counter instruments makes possible a transfer of risks from agents unable to bear them, or who would prefer not to do so, to those willing to speculate or who have an opposite risk "profile". The capacity to retain and absorb the risks must be calculated in connection with the financial resistance of the firm in question.

52. Other methods can also be envisaged in certain cases such as, for instance, paired (back-to-back) operations, i.e. by the simultaneous signature of a purchasing contract for and a promise to sell a given quantity of goods, a trading firm can avoid the price risks. In actual practice, however, such operations are rare, the very existence of middlemen being based on the fact that transactions are not paired.

Futures markets

53. The organized futures market or commodity exchange is a place established by an association of members in which economic agents who have different purposes (hedging, arbitrage and speculation) come together. Hence the possibility of transferring risks from agents who do not wish to bear them to those who hope to do better than the market.

Box 5

FUTURES CONTRACTS

A futures contract corresponds to a buying or selling agreement (to be carried out subsequently) concerning a given quantity of a specific product in which the future price to be paid or received, on conclusion of the agreement, is stipulated. The contents and maturities are standardized, while the amount to be paid forms the subject of daily quotations on an exchange organized for that purpose. This kind of contract offers its users a great deal of flexibility with respect to negotiability, liquidity and speed of execution (the possibility of closing out the initial position before the maturity date established is commonplace). These instruments are used mainly to manage short-term flows, but some of them have longer periods of validity, extending up to 36 months.

Box 6

OPTIONS

An option confers on its holder a right, but not an obligation, to execute a commodity transaction at a predetermined price, the so-called strike price, for a given period. The value or price of an option sold by one trader and purchased by another is called the "premium". The maturity date is the last day on which the trader can sell or exercise his right. There are two types of options, the call option which protects against the risk of a price rise and the put option, which protects against a possible fall in prices. Options are instruments proposed by the futures and over-the-counter markets. The purchase of options is the main formula which makes it possible to use the futures markets without exposure to liquidity problems. Options may be regarded in some cases as instruments offering a greater flexibility than futures contracts, particularly in countries where the banking structure is underdeveloped. These instruments render it possible, for instance, to guarantee a minimum price without suffering from cash-flow problems. One of the factors to be examined with interest at this level will be the choice of the suitable price for the exercise of the option, or the selection of a good insurance policy at a good price.

54. Contracts representing very specific batches of goods are bought and sold there. These futures transactions are carried out in an ordered and supervised way. Although a physical delivery can always be effected, in almost every case the transaction will be closed out by a reverse operation, the operator collecting or paying the difference in price. Contracts negotiated by commodities exchanges are, in fact, an agreement or entitlement by which a buyer and a seller undertake to carry out an operation on a given commodity at a price and on a date fixed in advance. These entitlements take the material form of highly standardized contracts which are thus fungible (the rights are perfectly assignable). They are registered with an organization called a clearing house which ensures the performance of the operations and replaces the buyer and the seller in the rights and obligations of the contracting partners.[8]

55. There are many futures exchanges (such as MATIF, CBOT, CME, LIFFE, CSCE, NYCE, COMEX, IPE and SIMEX) which are forums for trading in commodities and having different specific features.[9]

56. In short, several purposes, corresponding to the various constraints of the economic agents, underly the use of futures instruments, the three principal ones being hedging, speculation and arbitrage:

- Hedging: the general idea of futures markets is to compensate for the losses and gains on the physical market by equivalent gains and losses on the futures market;
- Speculation: a speculative operation consists in taking up a forward position in the hope of a future gain resulting from the favourable closing out of that position. A speculative operation on the futures market is profitable if, and only if, the expected direction of the movement of the price has more than offset the cost of immobilizing the initial margin and paying any margin calls during the operation; and
- Arbitrage: the principle of arbitrage is based on the exploitation of the differences between the spot and forward prices (spot/forward arbitrage), the prices of a contract between the various delivery dates quoted (forward/forward arbitrage), the prices of

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[8] The clearing house replaces the buyer and the seller and becomes the counterparty of each of them. Through its members, it guarantees the performance of the operations and eliminates the counterpart risk.

[9] See, on this subject, the report by the UNCTAD secretariat op.cit. (UNCTAD/COM/15/Rev.1), in which the various over-the-counter instruments are also described.

contracts negotiated at the same place or on different exchanges, the prices of different synthetic combinations of instruments (e.g. the combined purchase of futures contracts and a put option corresponds to the purchase of a call option), and so forth.

57. In addition, the commodity exchanges procure price data by publishing reference rates which serve as a basis for the negotiation of physical contracts and for the selection of the commercial formulas to be used. The futures markets serve, in fact, as vectors to transfer the risks from the economic agents who cannot, or will not, bear them to those who have the resources to do so. It is also the place in which information is exchanged, in a transparent way, and in which the prices of the primary commodities quoted are determined. These exchanges supply indications of the future prices and of the medium-term trend, data which will influence the decisions of the economic agents dealing with the physical commodities.

58. In addition to the coverage strategies offered by the organized markets, there are many instruments which provide protection against the harmful effects of fluctuations in the prices of the primary commodities. Forward contracts - over-the-counter contracts - are one of the formulas used to reduce the price risk; they are instruments similar to futures contracts but offering less flexibility, since the goods must in all circumstances be actually delivered. What is more, in the absence of an organized market, there is a counterpart risk.

59. Other instruments responding to the practical expectations of the economic agents are also available. Swaps (like all other combined or derived contracts) are, par excellence, basic tools that can give the economic agents who so desire the means of covering themselves in the long term. There again, the counterpart risk is present and the very fact that the contractual ties are based on the trustworthiness of the contracting parties demonstrates once again how important a firm's reputation is. As we have previously stressed, there are means of guaranteeing the successful conclusion of the operations and they should not be ignored. It is, consequently, important to adapt the individual forms of behaviour and to resolve the legislative problems[10] which would not be compatible with the commercial interests of the economic agents.

60. In short, the expression "commodity price risk management instruments and techniques" thus embraces a whole range of financial tools designed to manage the risks of price (and currency) fluctuations connected with the various commodities (agricultural produce, metals, minerals and oil). Futures contracts, options and foreign exchange contracts relating to commodities are instruments that, used for hedging, could considerably improve the commercial (and production) situation of the firms in the developing countries. As we have noted, they make it possible for exporters to protect themselves against future fluctuations in the prices of the commodities in question. Most of them are negotiated on the exchanges; nevertheless, banks and certain business firms organize tailor-made contracts, which are much used for oil, maize, sugar, wood, cacao, etc.

61. Nevertheless, there are various obstacles that hinder effective use of the financial risk-management services. We may mention three of them here:

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[10] See, on this subject, "Legal and regulatory aspects of financing commodity exporters and the provision of bank hedging line credit in developing countries" (UNCTAD/COM/56), by Nicholas Budd, White and Case, Paris, February 1995.

- ✓ The reputed creditworthiness of the enterprises having recourse to the risk-management instruments;
- ✓ The obligation to pay the fees or premiums in advance; and
- ✓ Local structural obstacles (exchange controls).

62. Many obstacles of a regulatory and technical kind can also be encountered. However, the main barrier is certainly ignorance of the functioning and characteristics of derivative instruments and of modern financing techniques.

G. Risks arising from gaps in the commercial infrastructure[11]

63. In the absence of effective procedures and of access to information, to modern communication techniques, to support services and to adapted logistics, a number of economic agents are marginalized and remain on the outskirts of international trade.

64. Trade efficiency has a direct influence on transaction costs[12], the number of participants and thus the creation of new trade flows. In the absence of specific commercial data and appropriate training programmes, some risks, which could moreover be avoided, may suddenly appear and shock the firms of the commercial nexus.

65. Trade efficiency responds to an urgent need: traders in the developing countries must become aware of the growing impact of information-processing tools and applications on international trade. The promotion and use of models that render it possible to reduce transaction costs and the risks linked to the absence of information (or incorrect information) must be considered.

66. In recent years, significant progress has been made in initiating more open and more dynamic trading relationships. Many countries, particularly developing countries and countries in transition, have made considerable efforts to liberalize their economies and adapt their trade policy to the new multilateral context. From this point of view, trade efficiency, which improves the rapidity, simplicity, extent and cheapness of commercial operations, is a valuable means of action: it constitutes the natural link between the vast objective of strengthening trade and development, on the one hand, and the practical measures to enable the international community to reach that objective, on the other.

67. Trade efficiency is a crucial area for the developing countries. Strengthening cooperation between the private and public sectors is the keystone of any success. Private development organizations, whether national or international, have different but complementary roles to play. An area of particular importance in which their energies should be combined is that related to international standards and to technico-legal devices connected with trade-efficiency measures.

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[11] See, for instance, on this subject, the "Report of the United Nations international symposium on trade efficiency" (TD/SYMP.TE/6), of 4 November 1994.

[12] According to certain UNCTAD estimates, these costs would amount to 7 to 10 per cent of the value of world trade.

68. To strengthen trade efficiency, companies require a good institutional framework. There are six key areas[13] that can be highlighted here:

- ✓ Services supplied by banks and insurance companies;
- ✓ Simplicity and transparency of customs transactions and procedures;
- ✓ Free access to trade information;
- ✓ Efficiency and reliability of transport systems;
- ✓ Appropriate telecommunications systems; and
- ✓ Adoption of relevant trade practices.

69. In this context, we think it is interesting to highlight the main elements that can lead to the appearance of risks along the commercial nexus; principally by bearing in mind the difficulties involved in any transaction relating to primary commodities and, to some extent, by briefly considering the main technical and logistic impediments to the use of modern marketing strategies.

1. *Services supplied by banks and insurance companies*

70. Resort to modern financing vectors, insurance products and risk-management instruments is crucially important for the promotion of the expansion of domestic and international trade. The developing countries must not remain marginalized, the more so since they have the possibility of adopting the necessary arrangements to improve their situation in these areas. Difficulties of access to the appropriate financial services damages the competitiveness of enterprises in the developing countries (particularly the LDCs) and constitute a major obstacle to their participation in international trade.

71. The companies which have no opportunity to use modern services experience enormous difficulties in handling the risks which beset them every day and in retaining their competitiveness vis-à-vis foreign economic agents. A number of activities could be carried out in the services area with due regard for the conclusions concerning the General Agreement on Trade in Services included in the Final Act of the Uruguay Round and the current negotiations in the WTO concerning the liberalization of financial services.[14] The following points might, for instance, be considered:

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[13] These six areas were included in the UNCTAD work programme at the eighth session of the Conference held at Cortagena, having in fact been identified by the ad hoc working group established by the Conference.

[14] According to the Final Act of the Uruguay Round, 76 countries committed themselves in favour of an agreement on financial services. Nevertheless, the proposals made by the member States have not been recognized as sufficient by certain countries and special negotiations were carried out at the end of July 1995. At that date, a "provisional" agreement was concluded making it possible to retain the best offer (apart from that of the United States) negotiated during the last two years, for an initial period ending on 1 November 1997. As things stand, the member States are negotiating to try and improve the original offer.

✓ Analysing the impact of the limitations and derogations relating to the financial services and their effect on the competitiveness of the trading companies;

✓ Examining the domestic regulations in force concerning the financing of trade, exchange control, taxation, insurance and international payments so as to ensure their compatibility with modern marketing strategies; and

✓ Authorizing the trading companies to hold foreign currency in order to acquire risk-management instruments that will increase their competitiveness.

2. *Simplicity and transparency of customs transactions and procedures*

72. One of the problems that can give rise to trading risks (delivery delays, ban on exporting or importing, etc.) is linked to the customs and administrative procedures of the countries concerned. These procedures are often slow, far from transparent and thus sources of uncertainty and risk. Speed of execution is not the only matter in question here, the predictability of decisions being particularly important. One of the keys to this problem is continuation of the efforts being made to improve cooperation between the private sector and the competent public authorities.

Box 7

CUSTOMS REFORM: ASYCUDA

UNCTAD has a customs reform and computerization programme: the Automated System for Customs Data (ASYCUDA). This is a data-processing software made up of various modules: import and export licences, checking manifests, customs declarations treatment and authentication, inspection, bonding and waiting regimes, customs accounting, etc. In addition, it makes it possible to incorporate data defined by the user.

This programme, which has already been installed in 68 countries, including 27 LDCs, has as its objective:

- To reform customs procedures and management so as to improve their efficiency;

- To assist Governments to simplify and harmonize trade procedures and formalities;

- To encourage the adoption of international standards, and particularly the EDIFACT standard, to facilitate international trade transactions; and

- To improve the reliability and updating of foreign trade data.

In two countries, for instance, Ghana and Mauritius, the use of this system has made it possible to reduce customs clearance times from one week to half a day.

3. *Free access to trade information*

73. Regular and instant access to accurate and intelligible trade information, and means of taking advantage of such information, also constitute one of the basic preconditions for improving trade efficiency. Inadequate and inaccurate data thwart planning projects and complicate operations still further when problems arise. In most developing countries, the environment is not really favourable to an efficient transmission of information.

74. For instance, we may quote the problem of disseminating the forward prices quoted by the main commodity exchanges. Even if traders in developing countries do not use the financial instruments to cover themselves, these prices are essential indicators for the determination of the physical prices. Many economic agents have no access to this kind of information and have no accurate idea of the price levels practised on the market. It is hardly surprising, therefore, that some of them can be misled by unscrupulous traders. What is more, the forward prices serve as a reference point for fixing a

multitude of price formulas used in trading contracts. Ignorance of the relevant data is consequently an undeniable disadvantage for the commercial agents and constitutes a hazard for those unaware of, or unable to update regularly, information of this kind.

75. To encourage the circulation of trade information and non-discrimination in the propagation of data, it would, for instance, be useful to:

- ✓ Stimulate the popularization and strengthen the process of promoting various sources of economic information which supply data on modern trade terms and strategies; and
- ✓ Promote training activities focused on improving understanding and utilization of various types of trade information.

4. *Efficiency and reliability of transport systems*

76. Another risk of some significance in the developing countries is that connected with the state of the transport infrastructure. This area, as we shall see in greater detail in chapter III, is a major source of risks; since the state of the infrastructure has a crucial influence on the duration of the transport operation, the correlation hardly needs demonstration. This aspect will, indeed, have an unquestionable impact on rapid and safe access to international trade. Consequently, to sustain the growth of international trade, it would be advisable to:

- ✓ Adapt existing transport regulations to encourage the use of commercial practices in the transport chain and stimulate domestic and international financing; and
- ✓ Incorporate specific improvements into transport operations, such as multimodal transport, the introduction of block trains, etc.

5. *Appropriate telecommunications systems*

77. The modern era has been characterized by the emergence of telecommunications and the globalization of data transmission[15]. New highly effective techniques, which are incidentally available at absurdly low costs, should be able to act as a springboard for the economic agents of the developing countries and assist them to obtain instantly the essential data they need to reduce the costs and risks linked to standard trading operations.

78. To take up the example developed in subsection 3 above, direct access to dynamic data systems such as "Reuters" or "Telerate" is a factor that can make a major contribution to improving the conditions of the economic agents in the developing countries. Models developed by consultant companies, banks or specialized firms make it possible to evaluate specific risks. For instance, J.P. Morgan proposes a "risk metrics" model on the Internet which posts up daily 900 volatility indices and 200,000 correlation indices, a number of which relate to primary commodities.

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[15] It was decided at the first ministerial conference of the World Trade Organization (WTO) that information technologies should be liberalized.

Box 8

THE GLOBAL TRADE POINT NETWORK (GTPNet)

Born of the United Nations International Symposium on Trade Efficiency (UNISTE), and strengthened by the fourth world meeting of Trade Point directors at Midrand, the Global Trade Point Network is a key component of the trade efficiency programme. In August 1997, 136 Trade Points had been, or were in the process of being, set up, while 30 other official requests had been received by UNCTAD. The main aim of this technical cooperation programme is:

- To improve the access of small and medium-sized enterprises - particularly those in developing countries - to the international trading system; and

- To reduce transaction risks and costs and encourage the improvement of trading practices, particularly by computerization and the dissemination of trade information.

A Trade Point is a place (whether physical or virtual) where:

- The data and the services essential for trading are inspected;

- The modern interactive communication techniques to disseminate trade data are promoted for the purpose of furnishing the economic agents with information on trade possibilities, customers/suppliers, procedures and regulations;

- An electronic bulletin board is used to display trade opportunities in the developing countries; and

- There is access to other networks and databases. The Trade Points have been gradually linked together to obtain a global electronic network.

In short, the promotion of trade information, new technologies (use of modern means of telecommunications) and the exchange of experience and know-how are the pillars of any sustainable advance in the trade of the developing countries, particularly in the current new economic and interactive context.

79. To promote the economic activities of enterprises in the developing countries, it would thus be necessary to:

- ✓ Determine the essential services for which the functioning of the telecommunication networks for local, national and international trade purposes can be effective and utilizable by all; and

- ✓ Help the economic agents of the developing countries to obtain access to information concerning trade practices via the modern means of telecommunications.

6. *Adoption of relevant trade practices*

80. As we shall see in chapter II, the risks and costs encountered in international trade are often the same as, or similar to, those of domestic trade. Their complexity is, however, aggravated by the very fact that many firms are involved, that more documents are used and that the ways and customs of the various participants are not the same, thereby making it sometimes difficult to understand what rules are to be applied.

81. There again, cooperation between the private and public sectors and the international agencies seems to be the only way of promoting the development of trade on the morrow of the Marrakesh Agreement. The public authorities have more than ever the duty of establishing a legal environment calculated to sustain the rise of the private sector, the international agencies supplying technical expertise and giving advice when it becomes urgent to do so.

82. In the light of risk management in commodity trade, there are a few basic points which should be emphasized:

- ✓ How to adapt the governmental policies of some developing countries to enable economic agents who so desire to take advantage of the benefits of modern risk-management techniques;
- ✓ How to make Governments aware of the impact of sovereign risk on access to credit, terms of financing, etc.;
- ✓ How to enlighten government authorities concerning the processes to be introduced to help their national economic agents to settle trade disputes;
- ✓ How to enable Governments to support the trading firms, i.e. to establish a favourable institutional and legal environment to make it possible for them to take advantage of commercial insurance, hedging strategies (price and exchange risks), etc.;
- ✓ How to improve the systems for monitoring the quality of the primary commodities; and
- ✓ How to ensure that the economic agents involved in commodity trade are able to handle the methods used internationally (e.g. knowledge of the INCOTERM standards, etc.).

83. To summarize this first chapter, the risks existing along the commercial nexus begin once the decision is taken to produce a given product. For the economic agents concerned, the producing action generates a considerable risk, a risk which has become all the more significant in that the government programmes supporting farmers (minimum prices, subsidies, etc.) are declining or even disappearing completely. In this area, the producers in the developing countries are already at a disadvantage vis-à-vis their counterparts in the developed countries, since the latter have the benefit of price-protection programmes and can, moreover, resort to various risk-management instruments and techniques. The hazards connected with production (uncertainty of the volume produced) can be managed through crop-insurance policies[16] and those connected with price fluctuations through the direct or indirect use of organized or over-the-counter markets.

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[16] Some of them are available in the developing countries but often only for firms of a certain size.

II. RISKS CONNECTED WITH THE EXPORT OF PRIMARY COMMODITIES

A. Introduction

84. The process of transferring goods from the local or domestic area to the international sphere entails the appearance of a number of specific risks to both the domestic seller and his trading partner, the buyer. Since the two agents have to trade together, they both incur counterpart risks. Despite the fact that the economic agents in the developing countries should not underestimate risks of this kind (in the past, many companies were defrauded overnight by unscrupulous firms), counterpart risks are usually greater for the buyer of basic commodities than for the seller, the sellers of basic commodities being, for the most part, small firms located in the developing countries. What is more, the counterpart risk is also increased by domestic policy problems connected with sovereign risks. Another type of hazard characteristic of the international sphere is the risk of monetary instability, a hazard which usually affects the sellers to a greater extent because they often lack the means to manage it. Various risks linked to the export process can also arise and affect the various agents involved As in the previous chapter, these hazards will be examined in greater detail below.

85. From Colombia to Viet Nam via Côte d'Ivoire, the developing countries are marching along the liberalization road. Like the barriers to international competition, State monopolies are being dismantled. The appearance of new private firms is, however, overturning the familiar scenery and the cartography of risks is no longer as intelligible as before. Trade transactions with the developing countries used to be carried out with parastatal organizations. Despite efficiency and free-trade problems, these institutions were regarded as relatively trustworthy counterparties: in the last analysis, it was the image of the State that was at stake[17]. The emergence of the private sector has gone hand in hand with the appearance of new hazards, and some would argue that the level of risk in the developing countries has never been so high.

86. As in the case of chapter I, the economic agents who have chosen an international vocation have to grapple with a plethora of hazards for which, as a general rule, they are not necessarily prepared. At the international level, these firms may be confronted, or be the source of, dangers similar to those present in the local area (risks connected with exporter financing, non-delivery or partial delivery of goods, physical problems, price fluctuations or resulting from gaps in the commercial infrastructure, etc.). The last of these are very often aggravated, since enterprises having different cultures[18], languages, laws and purposes come into relations and must, if they are to be able to trade in an adequate environment, try to find a clear, precise and unquestionable common ground.

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[17] States, or rather State organizations, are regarded as counterparties offering greater reliability than the private sector from the very fact that, to preserve their image, these economic agents will always, or nearly always, find ways of abiding by their most important commitments (if not, the term is then sovereign risk). The private business firms of the developing countries, even if they have every intention of meeting their obligations, sometimes find themselves in a situation such that they are no longer able to do so.

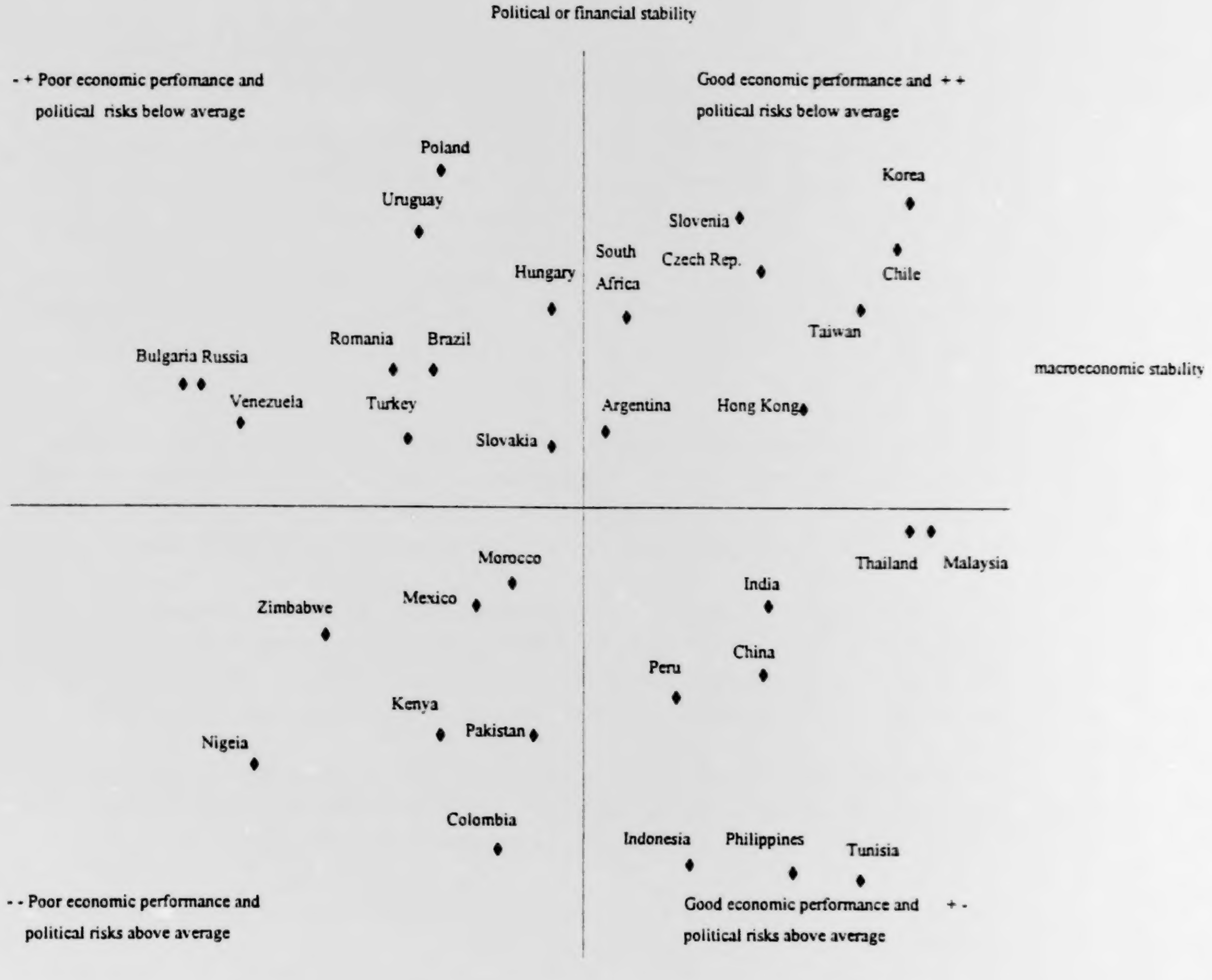
[18] In many African countries, a handshake will often confirm an agreement more surely than a contract duly signed and sealed by the various parties concerned.

87. Given the similarity of the situations, the risks described in chapter I for the local economic agents will not be analysed in greater detail here. Only the hazards of significant magnitude or having specific consequences will be examined.

88. Various obstacles can also give rise to risks; they are often interdependent and cannot always be analysed separately.[19] There are, for instance, problems connected with quality control (respecting standards), with trade accessibility, regulations, etc. What is more, the interaction between the two "families" of risks will be obvious if we consider, for example, the influence of the trade cycle of a country on the financial and economic situation of each individual local firm and thus on the risk linked with its financing.

Chart

Emerging countries: economic performance and political stability



Source: MOCI, no. 1266 of 2 January 1997 (the above countries were grouped according to a combination of 11 criteria)

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[19] The responsibility for certain risks can, indeed, be imputed to the economic entity under consideration whereas, in other cases, they can be the result of a State decision or stem from different economic agents. The "boundary of responsibility" is not always so clearly defined that it is possible to know who is at the source of the risk.

89. On the basis of these findings, this chapter will endeavour to examine first of all the two major groups of risks: those linked with sovereignty (or political risks) and those depending on individual counterparties (or commercial risks) - see the chart above. Secondly, a series of pragmatic solutions will be presented together with a description of specific risks where the "boundary of responsibility" cuts through both the public and the private sectors.

B. Country risks or sovereign risks

90. Failure to respect trade commitments may depend on factors which are peculiar to a firm, as we shall see below. Nevertheless, one of the characteristic features of a number of developing countries is the existence of sovereign risks, a factor that is exogenous to the firm in question. As a result of certain government decisions, companies may find themselves immediately incapable of meeting their obligations. A country's development and trading activities can be paralysed by internal conflicts, particularly of social or ethnic origin, or by the adoption of a form of governance whose approaches or practices are hostile to any growth.[20]

91. In fact, political risk embraces several interdependent families of risk mainly resulting from a government act or decision hindering the execution of a contract. We may quote as examples:

✓ The political risk properly so-called, which usually depends on the political system adopted and on government behaviour, such as non-convertibility of the currency, but also on corruption, terrorism, embargoes, boycotts, etc.;

✓ The risks inherent in conflict, war with neighbouring countries or instability arising from the influence of major Powers. These risks, which seem to be declining since the end of the cold war and the fall of apartheid, are not to be excluded in certain regions;

✓ The risks of direct intervention by the State: risks of confiscation of the goods, interference in management, expropriation, requisition, nationalization and interruption of sea and air traffic, but also of devaluation decided upon by the State or currency fluctuations tolerated or even encouraged by some States, etc.;

✓ Risks linked to the inconsistency and non-predictability of government and legal decisions (e.g. temporary measures restraining the delivery of goods), transfer risks (the central bank restricts the transfer of foreign currency), exchange control, moratorium on the payment of foreign debt or partial repayment;

✓ Risks of explosive social unrest arising from economic disparities or inequality of opportunities (measured, for instance, by the Gini coefficient) which culminate in strikes, lockouts, public disturbances, riots, demonstrations, etc.; and

✓ Residual force majeure risks such as natural or man-made disasters, epidemics, quarantine measures, etc.

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[20] To take a few examples only, the political, social and ethnic conditions prevailing in Rwanda, the former Yugoslavia, Angola, Cambodia, Congo and Democratic Republic of the Congo, or some prohibitory decisions adopted, for instance, by Myanmar will help to raise the level of sovereign risk and discourage potential partners.

92. The rates practised by insurance policies offering protection against political risks constitute a good indicator of the evolution of the risk level in recent years. A comparison between the number of countries by region and the level of rates in the contract guaranteeing against confiscation/nationalization (which is a contract regarded as representative of the level of political risk) will be a good illustration of this.

Table 2

Comparison of rates for contracts insuring against confiscation/nationalization between June 1992 and June 1997

Rate	Africa		Latin America		Asia		Countries in transition		Middle East	
	1992	1997	1992	1997	1992	1997	1992	1997	1992	1997
0.30				2	1	2		4	1	
0.50		3		3	1	3	1	1	2	8
0.75	2	3	5	2	3	2	1	1	2	2
1.00	3	3	5	4		3	1	3	2	
1.25	1		3	4	2		2		2	1
1.50	5	7		3	2	1		1		
1.75	3	1	2	1	1			3	1	
2.00	3	1	3		1	1	1	4	2	2
2.25										
2.50		1					15	1		
2.75										
3.00	1		2					3	1	1
3.25										
3.50				1		1			1	
3.75										
4.00	1				1					
5.00					1					

Source: Investment Insurance International (III)

93. In addition to the weakening of rates, a number of countries, such as the former Yugoslavia, had not been taken into account in 1992. In Africa and in Asia, for example, insurance against political risk was available for 23 and 15 countries, respectively, in 1992, whereas the corresponding figures for 1997 were 33 and 20.

94. Political risk is a profoundly destabilizing factor since, in addition to its direct impact on the national economic and social sphere, it damages the trade relations between the local economic agents and their foreign partners. For the private firms of the developing countries, this risk is an exogenous variable that seriously disturbs their efforts to be regarded as steady and trustworthy partners. Despite the present diminution in the seriousness and level of this kind of hazard, the question is still a crucial one, since these factors have a major influence on the granting of lines of credit and the supply of hedging strategies.

95. In addition to the uncertainty caused by an armed conflict, the State may decide overnight to confiscate, expropriate or nationalize a firm which had committed itself to delivering a consignment of goods or which had received a financial advance. The trade agreements binding that firm would then be in major danger of not being honoured by the very fact of that State decision. Although considerable harm would be done to the image of the country concerned and the national economic agents would be handicapped still further, it will be obvious that political will, or rather political sovereignty, is inconsistent here with economic and trade efficiency.[21] Political risk can also arise from the absence of explicit legal and commercial rules and/or from rules that are incompatible with the use of modern trading strategies.[22] Such a risk is in no way the result of a deliberate political will but is due to the present economic situation: the opening of markets and the transformation of the international trade situation have produced the instability in some developing countries of which we are all aware nowadays. States must bear in mind the impact of their rules (or absence of rules) on the economic and commercial fabric of their countries and adopt a suitable legal structure.

96. Business firms, banks and insurance companies try to assess at regular intervals the risks to be foreseen and, quite logically, are reluctant to commit themselves to firms located in an unstable economy or will do so on extremely restrictive terms and conditions. All else being equal, the higher the sovereign risk, the less trading companies and banks will be inclined to do commercial and financial business with the nationals of the countries concerned.

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[21] It is difficult in this type of situation to propose a solution that can basically change the kind of risk involved. Only a constant campaign to raise the awareness of the government authorities could eventually bring home to them the current and future implications for trade. Nevertheless, there are ways and means of insuring against or avoiding the various political risks (commercial and political risk insurance policies, some forms of structured financing, factoring, forfaiting, irrevocable and confirmed documentary credits, etc.)

[22] Two examples of interaction between government policies and the use of modern marketing strategies may be quoted here:

Exchange controls may prevent access to or the holding of foreign currencies, thus rendering the use of risk-management instruments impossible. An easing of these controls would improve recourse to such techniques while preserving the State from the risk of capital flight. In many countries, the exchange regulations in force often antedate modern financing and payment methods.

When financial instruments are used as hedging to protect a given operation, taxation policies and procedures should take the futures transactions into account and treat them as the complement to the physical transaction.

C. Counterpart risks

97. Counterpart risk is at present very important in the developing countries because the recent liberalization of their economies has brought about the appearance of new firms which usually have rather a weak credit standing and which are not necessarily familiar with the subtleties and mechanisms of international commodity trade. It is true that some commercial agents have already acquired significant experience in that area, but the radical transformation of the economic order and of the global regulatory framework has produced a basically different environment. Marketing methods have evolved and it thus seems essential to put together effective strategies to benefit from the opportunities now offered by the markets. Nevertheless, these small firms are more often than not confronted with major corporations which do not know them and which are going to assess their reliability.

98. The economic agents located in the developing countries have, at long last, ways and means of showing their mettle and becoming known to potential sources of financial backing.[23] Once again, the image of the entity in question is fundamental for this purpose and must be cultivated. As we shall see, there are not many rating criteria. What is more, the "youth" of many private firms that have recently made their appearance means that it is not possible to analyse historical trading behaviour and past performance.

99. In the absence of well-known reference points, the international banks, trading companies, importers, etc. adopt rather a prudent approach and are reluctant to commit themselves without serious guarantees. The commercial agents (exporters, local banks, national traders, etc.) doing business in the developing countries have thus to adopt an attitude compatible with present-day market conditions. Suitable strategies are open to them[24] and solutions can be found to meet the requirements of each of them (financial instruments available on the organized or over-the-counter markets or recourse to credit insurance, political-risk insurance, factoring, the use of warehouse receipts finance and letters of credit, but also the use of other strategies such as forfaiting, leasing, set-off operations, notes of hand, documents against acceptance or payment, documentary credits, etc.). If they want to survive in the present context, they are obliged to consider them and seek ways and means of determining what strategies can improve their operations in the long term.

100. The heart of the counterpart problem is linked to the payment and to the risks associated with processing or with non-delivery. One of the crucial moments of determining an international transaction is, in fact, that of deciding on the methods of payment. Picturesquely speaking, it is a question of replying to three questions: what?, when? and how? to pay.

101. The replies to these three questions will influence the counterparty decision. Apart from the trustworthiness of the agent with whom you trade, the terms proposed - invoicing currency, down payment, cash payment, payment on credit, simple collection, payment against invoice, documents against payment, documentary credit, etc. - will help to determine the financing and

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[23] See the UNCTAD report, "Counterpart and sovereign risk obstacles to improved access to risk management markets: issues involved, problems and possible solutions" (TD/B/CN.1/GE.1/3), of August 1994.

[24] It is true that a number of obstacles resulting from government policies can hamper recourse to tools of this kind. However, if the commercial agents of the developing countries are aware of the benefits of these strategies, they can make them known and contribute to the collective education which is essential to any modification in depth of public opinion which (when rational) should normally be reflected in domestic laws and regulations.

trading terms and conditions. If a transaction is based on prefinancing, it is a guarantee for the exporter, since he will have already received an advance payment on the product he is going to supply, but a risk for the importer who has paid out part of the sum due without having the certainty of receiving the promised goods. On the other hand, if the terms of the contract stipulate that the payment will be made in cash, the exporter will then have to bear the risk of not receiving any financial compensation once the goods have been shipped. It is thus crucial to adopt suitable strategies to ensure that neither of the trading partners is injured. Such situations must be examined even more carefully where the country is a high-risk one and the counterparties are new or unknown.

102. It seems essential to us to emphasize here that, even nowadays, there are many commercial agents who find themselves all too often in an awkward situation. This is a major problem since, if a default does occur - i.e. if the exporter is not paid or the importer is prevented from receiving the expected product - the reputation of the counterparty in question will be seriously discredited and future (potential) transactions complicated. All too frequently, it is only at the moment of the delivery of the goods that the economic agents wonder whether the agreement they had concluded was an appropriate one and if its terms entitle them to any means of redress. If questions of the kind come up at that specific moment, it presupposes that the firms concerned have not developed any methodology in advance for selecting coverage and assessing what instrument is best suited to their situation. When a transaction is to take place, it is essential that the risks be identified so that a suitable strategy can be selected when the contract is being signed.

103. The capacity to retain and absorb risks must be calculated in the light of the financial resistance of the entity considered. The developing countries seldom have the means to adopt high-risk "speculative" positions. That is, however, what they in fact do if they remain inactive. The present day is the ideal moment for considering the options that can be developed. If the opportunity is not seized when ripe, it is possible that the trade situation will deteriorate in the future. Indeed, if the economic agents of the developing countries are unable to take advantage of the market, the market will have no difficulty at all in imposing its own law. It is then probable that the small local firms will gradually disappear to make room for large conglomerates which will then enjoy a monopoly situation. It is vital, therefore, to recall one last time here the importance and the seriousness of the present situation: the economic agents of the developing countries must do their utmost to take advantage of the improved market terms, otherwise the opportunity may well disappear as fast as it appeared.

D. Evaluation and rating of sovereign and trading risks

104. As we have noted, international trading firms and banks which are interested in acquiring primary commodities - and thus in doing business with firms located in the developing countries - or disposed to finance the primary sector in those regions, are faced with different counterpart and sovereignty risks.

105. In the developed countries, the economic agents have ways and means of evaluating the performances of enterprises and companies, since they can refer to clear and precise criteria. There are a number of agencies that rate the financial side of companies or assess the solvency of debtors. Potential investors having the capacity to finance such and such an enterprise or such and such a project will select the most profitable project or enterprise but also the least risky one. They will examine the rating of the enterprise so as to come to a rational decision.

106. The great difficulty resides in the fact that only a limited number of entities located in the developing countries have been assessed. Organizations disposed to supply financing to the economic agents playing an important role in the primary sector of these countries have no reference criteria to examine. They are devoid of benchmarks and are often hesitant to take the risk of financing one entity or another. Although the determination of the probability of non-payment (the counterpart risk) is characterized by a whole series of factors, it is based mainly on the length of relationships (number of payment mishaps on record), the status of the entity in question (private company, public institution or government agency) and its location. What is more, as a general rule, commercial and financial organizations in the industrialized countries have no time to waste and, if no "recognized criterion" is presented to them, they will give up looking into the matter further and will abandon the idea of lending to anonymous firms in developing countries.

Box 9

RATING AGENCIES AND SOVEREIGN AND COUNTERPART RISKS

Rating agencies exist. They take account of various criteria in evaluating the overall position of an economy. Country rating is founded, for example, on a calculation based on sovereign, social (political stability), economic and financial risks, on the economic and environmental management of business, on the dynamism of economic growth, on the long-term growth potential, on the stability or otherwise of GDP and prices, and so forth.

It is worth stressing here that the evaluation of sovereign risks is a less exact "science" than the strategies for rating individual companies. It is relatively easy to illustrate this point by examining the mistakes made in the past. What is more, Richard Cantor and Frank Packer (of the Federal Reserve Bank of New York)[*] have demonstrated that the two most prestigious rating agencies in the United States have relatively similar opinions concerning the assessment of developed countries but that the "riskier" the country is, the more the risk assessments of the two agencies diverge.

Lastly, we can take the example here of the "country-risk" service of COFACE (we shall examine this company in greater detail in the next section) which supplies technical assessments of 100 developing countries, giving information on countries eligible for protocols and assistance loans and on the terms of and delays in payment (usual terms and conditions, payment times, expected developments and risk of non-payment). This agency also consults "Credit Risk International" to appraise the export risks - the rating system, founded on less than 18 months' risk-taking, is based on 75 criteria which take into account mainly the financial country-risk parameters together with those regarding economic and environmental business management and political stability.

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[*] See the article "Rating the rating agencies", The Economist, July 1995

107. Consequently, many traders, whether they are located in the industrialized countries or the developing countries, are concerned at the lack of accurate information concerning such and such a country or such and such a market. Despite the modern era of telecommunications globalization and the work done in the 1960s to define a series of social criteria capable of making the role of the economic indicators more relative,[25], there has been very little attempt to date to devise a

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[25] The United Nations Development Programme (UNDP) uses a "Human Development Index", but it is not of great significance in determining sovereign risk.

universal "directory" which would make it possible to look up country situations (economic, political, social, cultural, technological, environmental, etc.)[26], on a regular basis.

108. What is more, it might be interesting to examine the possibility of carrying out such work, with particular emphasis on the risks in the various commercial nexuses of the primary sector of the developing countries and on the means available to manage them.[27] Despite the existence of rating systems, the needs, possibilities, risks and resources of the economic agents trading in a specific area are not always reflected by criteria that necessarily represent a more general view.[28] Risks will be different according to the nature of the activities and the nexus in which the traders are operating. Although specific research on individual sectors is carried out regularly by organizations - rating agencies and banks[29] - of the private sector, the results are often confidential. Alternatively, obtaining and distributing accurate and objective information on the solvency of enterprises in the developing countries is a costly business. What is more, according to some experts, there are very few banks capable of perceiving and understanding sovereign risks in most of the African countries.[30]

109. Work on standardized information and rating systems for the primary sector in the developing countries could considerably improve the commercial situation of the firms concerned. The initial aim would be to inform the agents who so desired rather than to protect them. Nevertheless, the private and public agents of those countries could take advantage of such information to "place" themselves in the commodities trade. They could, in particular, benefit from a reference base to find out how they are regarded by their counterparties and which are their strong and weak points. They would thereby find it easier to classify their needs by order of importance and to distinguish what means they require to benefit from better terms of trade (the market conditions that are normally acceptable in the developed countries). Following the evaluation of a country, it could well be in a position - and this is crucial in the new global economic environment - to become aware of its weak points and take the necessary steps to adapt

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[26] See, in that connection, an article published in the Moniteur du commerce international (MOCI) of 11 January 1996 entitled "A l'heure de la mondialisation le risque-pays existe- t-il?" by Hugues de Jouvenel, general representative of Futuribles International and editor of the magazine Futuribles.

[27] There are, for instance, commercial means of integrating the political-risk component into management (use of irrevocable and confirmed documentary credits, credit insurance, factoring strategies, etc.).

[28] According to the Standard and Poor's agency - ADEF - the rating of a debt supplies an independent and professional assessment of a debtor's capacity to service his debt, both capital and interest, at the due dates provided. It is not a general evaluation of the quality of the issuer.

[29] Most banks dealing on the international markets have their own departments for estimating the probability of default on investments concluded or to be signed. One of the factors taken into account is sovereign risk: the more important it is, the more likely that the interest rates on loans made to a resident of the country concerned will be prohibitive. Moreover, certain ceilings (maximum amounts) will be determined above which the country in question will no longer be able to have access to financing. Sometimes, however, there are certain structured operations which make access to international financing possible by getting round these obstacles. As we have previously noted, several factors will usually be taken into account such as political and expropriation risks, price control systems and price volatility, exchange and interest rates, industrial portfolios and their economic viability, the sensitivity of the economy to an external shock, etc. Moreover, the banks are also very concerned about future prospects and the evolution/appearance of new risks: while an historical analysis is needed, it will not necessarily be the main question and a dynamic examination stressing a futuristic approach will be preferred.

[30] See Olivier Charles, "Exporters run for cover", Corporate Finance, April 1995.

itself so as to take advantage of the market logic. In addition, there may sometimes be serious differences of approach and of methodology between certain countries (North/South); an identical evaluation system could thus be interesting and help towards the recognition of some developing countries which do not know how to play their trump cards.

110. The trading partners in the industrialized countries would also have the opportunity to identify more easily the risks arising from such and such a commodity or such and such a country and could concentrate their efforts on ways and means of protecting themselves against such hazards. Indeed, in the absence of reliable information, a number of commercial firms are reluctant to trade with and prefinance operations in the primary sector of the developing countries.

111. The best way of summarizing this section is to borrow an old adage from another discipline: "prevention is better than cure". This maxim might, perhaps, help the various economic agents to understand the importance of trying to predict what they believe to be the unpredictable.

E. Credit insurance

112. The main role of the credit-insurance organizations is to underwrite the non-payment, counterpart and sovereign risks. This initial function has, however, evolved to give birth to a whole series of policies ranging from exchange-risk coverage to prefinancing. Although credit-insurance organizations can assume various forms (contracts containing precise specifications are submitted to the economic agents who so desire), they usually supply, on payment of a premium, protection against all (or some) of the potential losses that an exporter could suffer.

113. No two credit-insurance organizations are identical. Originally, however, all these institutions had one point in common: they could be likened to the secular arm of the Government. Nowadays, there are four different types of establishment to be found: fully State-controlled corporations, private organizations which underwrite sovereign risks on behalf of their Governments, parastatal institutions and, lastly, purely private companies which themselves handle export-credit risks, including political risks. Very simply, the current tendency seems to be for short-term insurance policies to be supplied by the private sector whereas medium- and long-term policies (those relating to significant periods of time and quantities) and those covering political risk to be handled directly or indirectly by the Government.

114. In view of the fact that most of the insurance organizations capable of playing a leading role are located in the developed economies, it goes without saying that the bulk of credit insurance is supplied to industrialized-country exporters trading with importers located in developing countries. Despite the danger of assisting a disguised government policy of subsidizing exports[31],export-credit insurance can significantly improve the conditions of exporters.

115. If credit insurance is a means of encouraging agents in the industrialized countries to trade with the developing countries, it is nonetheless an instrument worthy of careful consideration in the latter, since they could gain from export insurance and support activities, which are essential for

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[31] The European Union has interested itself in this problem, as has the World Trade Organization. No specific measure seems to have been adopted, however, and Governments are still free to use instruments of this kind to "promote" their exports. Nevertheless, markets have recently been opened up in many countries and private insurance companies can now propose contracts not only to nationals of their own countries but also to traders situated in foreign countries.

any development of their marketing. As we have observed throughout this study, it is crucial for the exporting companies in the regions concerned to have access to prefinancing and to a mechanism that will protect them against the risks of insolvency of their counterparties. What is more, the rise of export-insurance arrangements in the developing countries could not only facilitate but indeed encourage South-South trade.

116. Could the evolution of the situation in the industrialized countries serve as a model for the developing countries? Originally public in their inspiration, the credit-insurance organizations gradually passed into the private domain, largely as a result of the development of reinsurance companies and of the futures markets. The progress of these two sectors has made the Government's role superfluous (as protector against losses connected with risks) since the insurance companies now have the means to transfer the various risks involved.

117. In the developing countries, there are many insurance organizations but, as a general rule, they have not yet reached a similar stage of maturity. This situation, although it is the result of many factors such as inadequate financial and logistic resources, unsuitable regulations and insufficient knowledge and information, is mainly due, in fact, to the absence of integrated risk-management strategies that take account of the use of futures markets and the founding of reinsurance companies.[32] In such conditions, the State is then forced to play the role of stabilizer, i.e. to bear the risks instead of, and standing in for, the market! The rise of credit-insurance organizations, if it must pass through a stage of State support, may still be possible from the very fact that the international rules are vague. However, the means exist to replace the thankless, dangerous and expensive function of the "buffer State" by another vocation, that of the "support State", which could then have the aim of establishing an appropriate legal and logistic framework to promote the transfer of risks to those with the resources to bear them.

118. The monopolistic situation that used to prevail in the credit-insurance sector is slowly disappearing. Instead of devising antagonistic strategies, the insurance organizations are tending towards the setting up of programmes to strengthen cooperation and many partnership agreements have been signed.[33] In this framework, much activity has been undertaken by the Bern Union, the purpose of which is to "harmonize" the principles governing export-credit insurance and strengthen cooperation among the various organizations together with exchanges of information, assistance, expertise, etc. We should mention at this stage, however, that, although programmes of this kind have already examined a number of very interesting questions, certain subjects, such as long-term credits relating to the sale of commodities, have not been taken up by the "traditional" credit-insurance organizations. The new private firms could, consequently, seize this opportunity and propose solutions.

119. The operation of and the services and products proposed by a credit-insurance company such as COFACE can give some indications of what certain institutions could achieve in the developing countries and in the primary sector. It is important to note that contracts are proposed to cover

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[32] To use a simplified image, a reinsurance company can be thought of as a "cash box" in which funds are built up in the "good years" and then used to compensate losses in the "bad years".

[33] For example, between COFACE and ECDG, between JEXIM (the Export-Import Bank of Japan) and EXIMBANK (the Export-Import Bank of the United States), etc. In some cases, however, cooperation agreements have proved difficult to conclude and stormy negotiations have sometimes been reported.

foreign firms which grant credits or prefinancing to French trading companies. By analogy, some other risks underwritten by COFACE could be useful to the countries concerned.[34]

120. If the resources made available to the exporting companies situated in the industrialized countries are compared with those of their opposite numbers in the developing countries, there is often no common measure as regards the credit terms and the insurance systems supplied to them. Nevertheless, in the light of the recent development of credit-insurance organizations, a coming together and partnership agreements can, in certain conditions, become possible in the countries which have succeeded in identifying the problem (i.e. pinning down the main risks which are exposing their national economies to trading difficulties) and in establishing the legal and logistic framework calculated to encourage international trade.

121. The interest of this kind of cooperation is unquestionable. Apart from access to information and technical advice, one of the most important factors is the possibility, where it exists, of benefiting from one's partner's reinsurance. The new companies, however, do not always have the opportunity to make use of this option.

122. Indeed, like COFACE, the other stars[35] of credit insurance such as Euler (SFAC, COBAC), Gerlin-Namur (Germany/Belgium), Hermes (Germany), NCM (Netherlands) ECGD (United Kingdom) and EXIMBANK (United States, Japan) are assisting a number of developing countries or setting up more advanced cooperation programmes (partnerships). The collaboration between these companies and their opposite numbers in the developing countries has been increased still further by the fact of the partial or complete privatization of a number of them. This phenomenon can be observed more particularly in Latin America, a continent in which credit-insurance companies (often private) have flourished. In Africa, most credit-insurance companies are under the guardianship of the State and have great difficulty in achieving a critical size which would enable them to be profitable. Despite a certain amount of resistance (fears regarding sovereignty, etc.), a regional credit-insurance programme might be a viable solution for these countries. The European Commission endeavoured to inaugurate a credit-insurance mechanism (Eastern and Southern African Regional Insurance Mechanism (ESARIM)) which, at the moment, appears to have been stillborn. The "AFREXIMBANK", established in 1993 on the initiative of the African Development Bank, whose aim is to promote intra-African and extra-African trade by offering a trade-financing programme and guarantees concerning commercial and political risks, seems to be an institution well-placed to play a role in this area, the more so as the mandate to do so is contained in its Charter. The World Bank is aware of the problem and is also studying what means could be introduced at the regional level to underwrite the aforesaid risks. Lastly, apart from a few "eximbanks", there are very few private companies at the moment in Asia.

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[34] The following policies are offered: a with-profits exchange-negotiation policy, which covers the foreign-exchange risk from the negotiation stage to the payment of the commercial contract; exchange-rate guarantees at an advantageous price, particularly suitable when the exchange risk relates to tenders, aleatory contracts or estimated orders; and the import-export exchange policy, which covers variations in exchange rates over a business flow of exports and imports.

[35] For a more detailed description of the major credit-insurance companies, the reader is referred to annex I.

Box 10

COFACE, AN INSTRUCTIVE EXAMPLE

The example of COFACE (Compagnie française d'assurance pour le développement du commerce extérieur), the first of the great global credit insurers, can be developed here to illustrate the various services that a credit-insurance organization can supply. COFACE, which was founded in 1946 and privatized in 1994, is the property of a number of large French companies with four dominant shareholders (AGF: 31.1%, Scor: 20%, BFCE: 18.4% and Sfac: 16.5%). Now that COFACE is acting for its own account, it has to balance the premiums received and the claims paid. Although the group is active at the promotion and selling stages, its main role is, in fact, to underwrite the performance of export and import operations. To do so, it has recourse to the expertise of advisers abroad who supply information on trade terms and recommendations concerning export projects that are seeking a COFACE guarantee.

"CANVASSING" INSURANCE

Some of the insurance policies proposed are linked to promotion :

- The trade-fair policy: this is a guarantee to French firms taking part in a promotional activity outside the European Union when the participation costs are not offset by the sales concluded;
- The simplified promotion policy: this is available to French firms with a turnover of less than FF 300 million and proposes a guarantee against any loss when expenditure is higher than sales (the usual coverage is 65% of the loss);
- The standard promotion policy: this policy is available to firms having a turnover of not more than three billion French francs and is similar to the preceding one;
- The ANVAR additional assistance policy: extra coverage for the promotion policies;
- The COFACE individual mission policy: this is intended for small and medium-sized enterprises with a turnover of less than FF 300 million. COFACE cooperates to the extent of 50% in the costs of an individual canvassing mission abroad. In the case of success, the insured firm reimburses to COFACE, two years after the first trip, 6% of the export turnover achieved;
- Exchange-risk insurance policy: in view of the fact that the enterprises have to propose price lists to their future partners, COFACE offers the Change Import Export (CIME) policy covering exchange risks from the canvassing stage onwards.

This organization insures 20 per cent of French exports. In 1995, with a turnover of 2.5 billion francs, it covered 175 billion francs of exports and 70 billion francs of major projects. It should be noted here that the main areas insured by COFACE are the food and agriculture, iron and steel, other metals and textile sectors which, according to the year, may represent more than half the group's activities. In addition to 22 regional directorates and a network of specialized agents in France, COFACE is represented abroad by means of subsidiaries in London, Frankfurt, Vienna, Milan, Madrid, Singapore, Hong Kong, Tokyo and New York[1]. It may be worth mentioning here that, unlike ECGD in the United Kingdom, COFACE carries out legal work and research but does not underwrite legal risk or, in other words, can never be required to compensate a policy-holder if a security that had been demanded should prove worthless at the moment of the loss. During an export operation, a company is subjected to a manufacture risk or to a credit risk. To cover himself against these risks, the economic agent who so desires has a choice among three types of insurance policies:

The specific policy: which covers only a single transaction specified in advance. This policy relates more particularly to heavy equipment and machinery;

(continued on next page)

Box 10 - contd.

The subscription policy: which establishes a framework defining the general conditions and simplifying access to the guarantees while leaving the enterprises free to select the transactions to be insured; and

The global policy which protects the exporter's entire turnover.

According to the contract selected, the guarantee covers political risk, commercial risk or both.

In general, the cost of the guarantee has two components: the basic premium, which is independent of the duration of the guarantee and a premium proportional to the duration of the risk to be covered. The price to be paid will depend on the type of policy, the nature of the risks covered and the status of the counterparty and of his country of origin.

"MARKETING" INSURANCE

While others relate to the sale properly so-called, the contracts below here are offered by branch of activity:

For consumer goods, there is the GCP (Globale, Commerciale et Politique) policy and the simplified formula GCP SUPER S, which are valid for one year and renewable by tacit agreement. Almost the entire export turnover is covered against counterpart risk but, in the case of sovereign risk, the company must specify the countries in which it wishes to be protected.

For light or mass-produced durable goods, there is the BF policy which is global, insures against the commercial credit risk and covers political risk for countries designated in advance.. The EA policy is a floating one that gives traders the choice of the risks they wish to cover: political and/or commercial risks, credit risk and manufacture risk.

For heavy equipment or equipment manufactured to order, large industrial complexes and working or research markets, specific policies are offered by COFACE in view of the nature and complexity of the transactions (which often include medium-term or even long-term credit). The contracts proposed will usually depend on the nature of the risks (counterpart or sovereign), the entity which is bearing them (banks, traders, etc.) and how advanced the product or service to be insured is (e.g. if there is a manufacture risk).

Side by side with these sectoral contracts, COFACE proposes other insurance policies dealing with distinct risks. A guarantee is offered to non-resident banks which grant financing to French exporters. Another covers the repayment of the compulsory loans for French exports. A third insures lenders who discount without resort to suppliers' credits. A specific policy, the economic-risk guarantee, is also offered to protect the trader against increases in his cost price during the execution of contracts for the export of equipment. This policy, however, which contains some very restrictive clauses, is de facto reserved for major exporters.

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[1] On 1 September 1996, COFACE opened a representative office in New York to monitor, coordinate and manage the company's various interests in the United States, which take the form of an indiret presence as a shareholder in the Veritas Group, a trade-information organization active in the United States, in Mexico and in five other Latin-American countries; as a partner of Unistrat, a political-risk insurer, and a partner of CNA Continental, one of the major United States IARD insurers. In addition, in October of the same year, the COFACE group selected Chile to establish there its first export-credit insurance company. COFACE has a majority shareholding ($4 million), the other shareholders being the local subsidiary of AGF (which controls the third largest Chilean insurance company), BNP and the Banco de Desarollo. COFACE Chile is intended not only for French companies that wish to set themselves up in that country but also for a clientele of local enterprises. The company in question belongs to the Credit Alliance association, an international network of credit insurers having 19 members operating in 27 countries

Source : MOCI, various issues, including No. 1254 of 10 October 1996

Box 11

PREMIUM CONNECTED WITH POLITCAL RISK

The War Risks Rating Committee, the London insurers' committee, classifies countries in various categories. Supplementary premiums are calculated when there is a war risk in the country in question. For instance, Croatia and Slovenia have just left this group and no supplementary premium is advised any longer for air and sea cargoes shipped to or in transit through these countries. On the other hand, Burundi has recently been included.

Certain countries are not classified. The insurers can then apply premiums at their own discretion. Although Georgia has just been crossed off this list, higher premiums than those applied to other countries are recommended since it is now classified as a high-risk country.

An illustration of the level of average costs generated by this kind of risk is given below for a number of countries: (Source: III, indicative rates, comparison of June 1992 and June 1997).

Country	Insurance: against impossibility of executing the export operation (including the risks of non-payment, cancellation of licences, etc.) (in %)		Insurance: against confiscation and nationalization (in %)	
	1992	1997	1992	1997
Cameroon	+2.00 to 4.00	+2.00 to 4.00	+1.50	+1.00
Côte d'Ivoire	+3.00 to 6.00	+2.50 to 4.00	+1.50	+1.50
Kenya	+3.00 to 6.00	+3.00 to 4.00	+1.00	+1.00
South Africa	+2.00 to 4.00	+1.00	+2.00	+0.50
Ghana	+2.50 to 3.00	+2.00 to 3.00	+1.00	+0.75
Uganda	more than 6.00	+2.50 to 3.50	+4.00	+1.50
Zimbabwe	+2.00 to 6.00	+2.00	+1.25 to 1.50	+0.50
Argentina	+2.00 to 5.00	+1.50	+0.75 to 1.00	+0.40
Brazil	+2.00 to 6.00	+2.00 to 3.00	+1.00	+1.00 to 1.50
Chile	+2.00 to 4.00	+1.00	+0.75 to 1.0	+0.375
Colombia	+3.00 to 6.00	+2.50	+1.00	+0.50 to 0.75
El Salvador	+4.00 to 6.00	+3.00 to 4.00	+2.00	+1.50
Mexico	+1.00 to 2.00	+1.50 to 2.00	+0.75	+0.65 to 0.80
Paraguay	+4.00 to 5.00	+3.00 to 4.00	+1.00	+1.00
Peru	+6.00 to 8.00	+2.00 to 3.00	+2.00	+1.25 to 1.5
Uruguay	+3.00 to 6.00	+1.00 to 2.00	+1.25 to 1.50	+0.50 to 0.75
Venezuela	+3.00 to 5.00	+3.00 to 4.00	+0.75 to 1.25	+0.75 to 1.00
China	+1.75 to 3.00	+1.50	+1.25	+1.00
South Korea	+2.00 to 3.50	+1.00	+0.75	+0.25 to 0.50
India	+1.50 to 2.50	+1.50	+0.75	+0.50
Indonesia	+1.75 to 3.00	+1.50 to 2.00	+0.75	+0.50 to 0.75
Malaysia	+1.50 to 2.50	+1.00	+0.25 to 0.50	+0.25 to 0.50
Philippines	+3.00 to 6.00	+2.00	+1.75	+0.75
Sri Lanka	+2.00 to 3.00	+2.00 to 3.50	+1.25 to 1.50	+1.00 to 1.25
Taiwan*/	+1.00 to 3.00	+0.75 to 1.00	+0.50	+0.25 to 0.50
Thailand	+1.50 to 3.00	+1.50	+0.75	+0.25 to 0.50
Viet Nam	+3.00 to 6.00	+3.00 to 4.00	+4.00	+1.50

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*/ Taiwan Province of China

123. Recourse to private credit-insurance companies such as Lloyds-Bain Hogg (20 per cent of the market) can supply specific guarantees to cover some transactions. Companies of this kind offer a useful alternative approach to insuring (or reinsuring) risks that could not be covered in any other way[36]. When the company is well-known or has a good "historical background", the main counterpart and sovereign risks are covered quite as a matter of course, the contracts proposed for political risk, for instance, being under the headings "insurance against impossibility of executing" and "insurance against confiscation" (see box 11). All else being equal, the premium to be paid to cover a trading operation will be the larger, the higher the risk conditions in the country in question.

124. To illustrate the role of the credit-insurance organizations in the financing of primary commodities, we may conclude this section by taking two examples - among many others - of operations recently carried out in developing countries. The first concerns the provision of insurance to nationals of the industrialized countries operating in a developing country, while the second relates to a trading transaction for the account of economic agents located in a third country.[37]

- The Australian export credit agency EFIC has extended an insurance contract against sovereign risk in Argentina, in an amount of US $200 million, to cover a mining project (gold and copper). It proposes to supply guarantees in partnership with other credit-insurance organizations, European and American. The Australian group MIM Holdings has 50 per cent of the project (which is valued at $990 million), the rest being in the hands of Río Algom (a Canadian company) and North (an Australian one). The project in question, which is due to begin in the second half of 1997, will have an estimated life of 16 years and an annual production of 64,000 ounces of gold and 180,000 tons of copper.

- The ECGD (Export Credits Guarantee Department) is an organization established in 1919 to promote United Kingdom exports. It is currently active in 16 countries, including Argentina, Brazil, Egypt, Kazakhstan, Lebanon, Poland and Viet Nam. In addition, this agency has just supplied guarantees for two energy projects in China. The first, situated in the province of Jiangsu, concerns a coal-fired power plant of 3 x 350 MW installed by Black & Veatch and financed by Black & Veatch International, General Electric and Babcock & Wilson. BZW is responsible for organizing and raising a loan of US $30 million, repayable over 12 years at a fixed rate of 6.6 per cent. Similarly, the second project, which relates to the installation of a coal-fired power station and ancillary equipment (with a yield of 2 x 350 MW) by Mitsiu Babcock Energy[38] in the province of Fujian, also underwrites a consortium loan (arranged by Socgen of London, in which Barclays, Midland and

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[36] That is to say if the transaction cannot be underwritten because the exported product is not sold in sufficient quantities in the country to interest a traditional credit-insurance company or if the terms of payment are unusual or, again, if it is difficult to find a specific contract (e.g. if it is desired to cover the manufacture and non-delivery risks of an offset agreement order).

[37] See, on this subject, Project and Trade Finance News, September 1996.

[38] Mitsui is, moreover, in a joint venture with Siemens to develop this project.

Paribas are participating) at a rate of 6.6 per cent, repayment being based on a period of 16 years.

125. Such pragmatic illustrations clearly indicate the versatility[39] of these institutions (see annex I) and the fact that large-scale operations would be difficult to carry out, particularly in developing countries, without resort to such guarantees. It is indeed probable that no firm would wish to participate in such projects without protection against the various risks inherent in them.

F. Brief survey of other instruments for managing sovereign and counterpart risks

126. If insurance schemes sometimes constitute an effective technique for providing against the various hazards of international trade, they are not the only instruments available to handle counterpart and sovereign risks. There are some alternative techniques that may be mentioned here to combat this type of risk and improve export-credit financing:

- **The documentary credit**[40] is an instrument which makes it possible to manage the counterpart risk if the documentary credit is irrevocable and the political risk if it is both irrevocable and confirmed. It meets the specific needs of the economic agents and may be compared (all due allowance being made) to over-the-counter procedures;

- **The commercial letter of credit**, a guarantee of payment issued by a bank for the account of an applicant for credit, is an instrument that can also be used to cover the risks under consideration. Although much older than the documentary credit, this technique becomes relatively comparable to it when warranties are attached (authentication of the signature and confirmation). What is more, many economic agents who continue to use the letter of credit state in their opening text that the letter in question is subject to the Uniform Customs and Practice, ICC Publication No. 500 (see footnote 45);

- **Factoring** has already been defined in chapter I. The factor bears the risk in place of his client. It should, however, be stressed here that some restrictions may sometimes appear[41] and that certain specific conditions have to be met by an economic agent resorting to this kind of procedure;

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[39] The credit-insurance organizations offer various types of services. In addition to pure insurance against counterpart and sovereign risks, they propose payment guarantees to banks and other financing organizations in respect of export credits (or projects) and can sometimes themselves supply financial support on favourable terms (interest rates). What is more, they develop networks of subsidiaries abroad enabling them to call upon known partners able to transmit reliable information on the solvency of clients. COFACE, for example, has 18 partners covering 46 countries throughout the world such as Cameroon, Burkina Faso, Côte d'Ivoire, Togo, Benin, Gabon, Morocco, Tunisia, Argentina, Brazil, West Indies, Chile, Costa Rica, Ecuador, Mexico, Peru, Bulgaria, Hungary, Poland, Romania, Czech Republic, Slovakia, Slovenia, Syria , Yemen, etc. It also offers a proximity service in about 30 countries. A quick glance at these questions will have to suffice, since they will not be discussed in greater detail in this study.

[40] Reverting to section G of chapter I (Risks arising from gaps in the trading infrastructure), we may mention that some new software programs for learning techniques connected with the documentary credit have come out. Loc, for instance, is a software program (issued by a young company called Incol Software Corporation) for learning to use documentary credits in accordance with the Uniform Customs and Practice for Documentary Credits prepared by the International Chamber of Commerce (ICC No. 500). After this learning process, it is quite possible to create an opening page of a letter of credit in three different formats.

- **Forfaiting** is a specific procedure for discounting medium- and long-term export receivables, which are either renegotiated on the secondary market or financed by the forfaiter on the Eurocurrency market. In fact, this is a very useful method when an importer wishes to buy a product which he cannot prefinance and which his counterparty cannot possibly export without credit. The two traders can have recourse to the services of a specialized bank which will be prepared to acquire, for a specified period, the debt receivable (for an amount below its nominal value) and to be repaid, on the due date, by the importer or, in case of need, by a guarantor. Even if the economic agent having recourse to this kind of strategy receives complete protection against counterpart, sovereign and exchange risks, forfaiters are rare (they are mainly large international banks[42]) and generally concentrate on long-term operations on a fairly large scale. Recently, however, the major banking groups have been showing renewed interest in the primary sector and this may make it possible to use the process for the marketing of primary commodities in the medium, or even the short, term; and

- **Asset-backed financing (securitization)**[43]. This, too, is a method of assigning on a non-recourse basis all or part of a trader's commercial debt to an ad hoc vehicle (sometimes a trust or a common receivables fund) which refinances itself in its turn on the organized market of negotiable debt instruments (commercial bills or "commercial paper"). Hence it is possible to obtain financing and a payment guarantee, while avoiding counterpart and sovereign risks. Despite the many advantages of this instrument (improvement of assessment and rating and thus of the associated credit terms), setting up a securitization programme takes time and is quite expensive (in addition to the cost of issuing the debt securities and the operating costs, there are also some quite heavy costs connected with the technical packaging). That is why securitization is mainly, if not indeed solely, of interest to firms of a certain size with a suitable accounts department. Many examples can, however, be quoted in several developing or emerging countries such as Mexico (oil and steel), Venezuela (oil), Brazil (aluminium, ores, iron ore), Argentina (oil) and Indonesia (gold). The reader is referred to box 12 below for an outline description of the machinery used.

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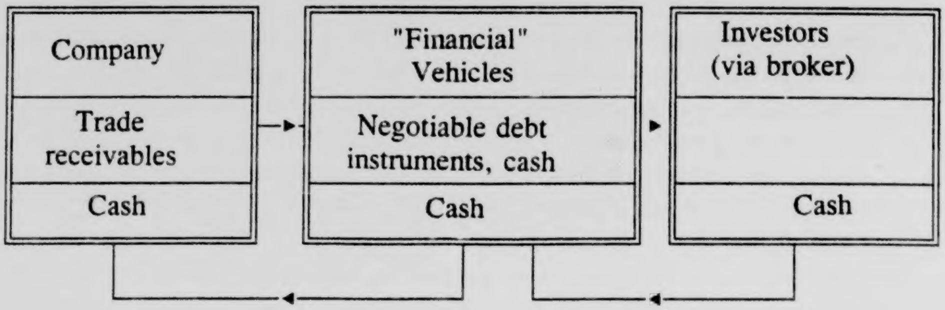
[41] For example, economic or credit risks of political origin are not usually borne by the factor. In addition, where there is a dispute between the commercial agents or when the firm resorting to factoring does not transmit all the information concerning its customer, the factor may not wish to bear the risk. He may not wish to become involved, either, if the counterparty is really too high a risk.

[42] The Banque des échanges internationaux (BDEI), for example, a subsidiary of the Crédit Lyonnais, specializes in forfaiting. It enables some economic agents trading with partners in countries dependent on short- and medium-term credits (e.g. China, Philippines, Indonesia, Thailand, Viet Nam, Romania and Croatia) to have the possibility of financing themselves in this way. Some Indian economic agents have recently begun to use this facility to finance themselves directly abroad by supplier credit.

[43] See, on this subject, "La titrisation, une autre solution pour le financement des comptes clients", by Jean-Pierre Gaertner, MOCI, No. 1252 of 26 September 1996.

Box 12

THE SECURIZATION MACHINERY



Source : Frédérique Louise Goldenbaum / ABN-AMRO.

127. All too often, exporters make use of instruments or strategies (when there is any use of instruments) which bear no relationship to the level of risk in question. In every payment operation, security will entail a cost, a cost which may not be at all proportionate to the risk to be run. Export and import trading companies, when they are defining methods of payment, should in fact adopt a risks/costs approach. Opting for "too liberal" methods of payment can entail a risk which would not be sustainable, whereas using a much more rigid structure could compromise the sale which would certainly be stolen by other traders offering more flexible terms. The response to this problem consists in selecting terms of payment which reflect the real risk of the transaction and thus constitute the best compromise between not being paid (or not receiving the goods) and being unable to put the transaction through. In short, such behaviour would encourage the maximization of profits while minimizing the risks involved (see annex II).

128. A very important factor when the payment instrument is being selected is the determination of the conditions to be adopted and the terms for the payment. A recent survey[44] has revealed that 70 per cent of the documents submitted in connection with letters of credit contained one or more errors.

129. Other difficulties can also arise with instruments such as the documentary credit which are nevertheless supposed to provide a significant degree of security. For example, if the expiry date is not respected or if the amount and/or the quantities differ from those stipulated in the contract or, again, if the documents are not consistent, reservations may be entered by the notifying (confirming) bank leading to non-payment of the firm unless and until the other parties to the documentary credit (i.e. the issuing bank and the applicant for the credit) cancel the said reservations. However, signing a contract linked to a documentary credit issued subject to ICC publication No. 500[45] provides greater protection against unauthorized confirmation risks which may stem from the issuing bank (e.g. if the latter is not creditworthy, if the transferred funds have

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[44] See Harry Twells, "Scope to reduce costs?", Credit Management, January 1996.

[45] International Chamber of Commerce (ICC) publication No. 500 describes the Uniform Customs and Practice for Documentary Credits.

been stolen as a result of political events or if the issuing bank decides to set the debt off against a claim it has against the applicant for the credit) or from the credit operation itself (i.e. if the documents issued are not consistent or if the issuing bank - and by the same token the confirming bank - refuses to pay because of fraud).

130. To avoid lawsuits and other disputes which can arise and, in particular, to protect oneself against the risk of non-payment, a suitable code should be observed. The best way of achieving this aim is to comply with certain standards and respect various harmonized rules which are recognized by the international community. In this way, arbitration procedures will be simplified, particularly for the economic agents located in countries where there is instability as regards legal status, the local judge's appreciation of economic law and the suitability of institutions[46] (please refer to annex III).

131. To sum up the last two sections, it is essential to select a marketing technique suited to the needs of the economic agent, i.e. to choose inter alia the appropriate instrument and the adequate contract and to examine what remedies are possible before clinching the deal. Such a strategy is desirable whatever the size of the transaction. It should be noted that, beyond a certain threshold, firms located in the industrialized countries will be reluctant (or quite simply unable) to deal with counterparties whose risks are too high. The French Banking Commission, for example, carries out an annual survey among the principal national credit organizations in order to identify the movement of debts outstanding (both domestic and international) which are regarded as doubtful. Following that investigation, the French banks are then required to make a provision to protect themselves against excessively high levels of risk. The lessons of the "tequila effect" or, more recently, the instability of the Asian markets have highlighted the emergence of a new hazard: the systemic risk. This is, in fact, a risk whereby the incapacity of a counterparty to meet his obligations on maturity in the framework of a payment system or a market leads to the appearance of the same problem for other firms in a chain reaction.[47]

132. The probability of this kind of risk seems lower in the primary sector than in other branches of activity. The bankruptcy of one company can, however, be devastating for a country's image. Similarly, uncertainty, or even more particularly a violent change, in the legal and political framework of a country can produce a whole series of "shock waves" that may affect the entire international equilibrium. These facts are all the more unquestionable when we consider large-scale transactions and/or the use of instruments that have a strong leverage effect. Such transactions nevertheless appear to be unavoidable (particularly in the mining and oil sectors) and modern risk-management strategies bring about a real improvement in marketing terms when they are used properly. To avoid any mishap, simple but almost obligatory prudential rules should be adopted (see section H of this chapter below). Nevertheless, no one must forget that the benefit derived will depend entirely on the efforts made!

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[46] Utilization of the principles of organs recognized by the international community makes it possible, as well as providing against certain risks, to respect neutrality among the various economic agents. For instance, ICC recommends the inclusion in contracts of the following standard clause: "All disputes arising in connection with the present contract shall be finally settled under the Rules of Conciliation and Arbitration of the International Chamber of Commerce by one or more arbitrators appointed in accordance with the Rules". This is a prerequisite but is not sufficient in itself since the place, the language to be used, the applicable law, the number of arbitrators and the way they are to be selected should, for instance, be mentioned.

[47] Between 1993 and 1994, the flows of private non-banking capital to Mexico fell from 24 billion United States dollars to less than one billion, while capital flows to Latin America declined by 20 per cent.

G. Trade-financing problems and possible solutions

133. In close relationship with the methods of payment, the crucial problem arises of financing in the developing countries. In theory, there are many possible ways of mobilizing finance for trade, such as direct bank loans or recourse to the financial markets. However, from the very fact of the inadequacy of their own capital, on the one hand, and the feeble response of the capital market, on the other, firms in those countries have enormous difficulty in obtaining funds. The more fragile the entity, the more difficult the problem. Consequently, it is hardly surprising to note that some isolated economic agents, such as small farmers, are the least favoured ones and often have great difficulty in obtaining seasonal credits. Traditionally, the financing sources available were based on informal borrowings from the local economic fabric (families, friends, neighbours, etc.) or on access to subsidized loans.[48] However, in addition to the various strategies set forth in the preceding section, there are several other sources of financing (or prefinancing) that exist. They are, for instance, bank loans (with single or instalment repayment), leasing[49], ongoing credits (lines of credit), and documentary credits (especially those containing so-called "red" or "green" clauses). Nevertheless, no financial organization will, in normal circumstances, be prepared to grant a loan without adequate collateral security.

134. Financial institutions, whether international or local, are less and less inclined to run the risk of advancing funds to economic agents whose reputation is unknown to them. They will be very disinclined, indeed, to extend credits to high-risk counterparties in a high-risk country. One solution is to give the creditor security pledges. In principle, there are many pledges that can be conceded, such as promissory notes[50], customers' accounts or even the charges paid by airline companies to overfly a national territory. More realistically, however, at any rate in the developing countries, a safer commercial collateral will be required. There are traditionally a number of items that have been and still are used as collateral such as real estate, stocks and shares, insurance policies, motor vehicles, jewellery, etc. As regards financing of the primary sector, however, one of the best collateral securities that can be considered is based on the sole resource available, namely, the commodities themselves. To use the commodities as collateral, it is necessary to structure the transaction in such a way as to ensure that the required conditions are respected.[51] In this way, it would be possible to have recourse to international financing (at several points above the interbank rates - see annex IV) and thus reduce by at least 10 per cent the annual rates of interest which can attain over 20 per cent, even 30 per cent, in some countries (African or Eastern European).

135. To date, commodities have hardly ever been used in this way by the economic agents from the developing countries. This is largely to be explained by the absence of suitable institutional and

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[48] These two sources do not, however, fully meet the expectations of the economic agents concerned since, in the first case, financing requirements go well beyond local financial resources and, in the second, administrative and bureaucratic procedures and the prohibitive costs relating thereto are dissuasive factors.

[49] This is a method of financing based on an assignment. The lessor (owner of a given piece of property) assigns the right to its use to the leaseholder (user) against the payment of certain sums over an agreed period. There are, in fact, two major leasing families, the finance-lease and the exploitation-lease contracts.

[50] This is a legal obligation to repay a loan together with the interest due.

[51] "Collateralized commodity financing, with special reference to the use of warehouse receipts" (UNCTAD/COM/84), July 1996.

legal structures. Moreover, very few local banks have sufficient experience in the matter and only a handful of international financial institutions are in a position to play a role in this process.

136. The obstacles are, of course, many but it should not be forgotten that the entire development of United States agriculture was made possible by the use of similar strategies, albeit less elaborate ones. Nowadays, a commercial credit containing a "green" clause backed by a commodity stock the value of which is guaranteed by a forward covering operation, can constitute an effective means of obtaining financing on interesting terms while encouraging the establishment of a climate of confidence and even of certain quality standards.

H. Prudential rules needed to avoid the risks inherent in the use of financial instruments[52]

137. As we saw in chapter I, futures instruments can underpin several operations according to the wishes of the economic agents concerned. In the case that interests us, it is essential that these financial tools be used in the context of a hedging operation,[53] i.e. as a guarantee against fluctuations in prices, in exchange rates or in interest rates. The firms wishing to resort to such methods to improve their trading performance must, consequently, respect scrupulously certain simple basic rules and install the appropriate logistics.

138. It would be foolish to rely solely on the individual's sense of responsibility to prevent speculation or irregular acts. Indeed, it would be pointless to replace one risk by another. Without the adoption of an adequate framework, resort to futures instruments can lead, in addition to the systemic risk, to a number of hazards such as credit, market and liquidity risks, mistakes regarding the reference periods, problems concerning the settlement dates[54] and other problems with respect to operational and legal decisions.

139. The underlying objectives of the establishment of prudential rules and other suitable pragmatic conditions are as much microeconomic as macroeconomic. Three supervisory levels should be considered:

- **The governmental level**: a specialized organ should be set up - e.g. within a central bank or a ministry of finance - to monitor and regulate the use of risk-management instruments and, especially, to ensure that the rules established can, while preventing potential abuses, facilitate the use of appropriate strategies (particularly hedging).

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[52] For a more detailed account of this subject, the reader is referred to the UNCTAD handbook "Company Control and Management Structures: The basic requirements for a sound use of market-based risk management instruments" (UNCTAD/ITCD/COM/MISC.1), 1996.

[53] In actual fact, a strict correspondence between the physical position and the futures position is very often difficult to obtain (there is a residual basis risk) and a "more dynamic" hedging would often contribute a significant degree of flexibility. It is, however, essential to be sure at all times that the futures positions are in keeping with the hedging requirements and with the financial standing of the economic agent in question. Any lack of control or any breakdown in the monitoring system could be devastating for the firm having recourse to this kind of strategy and, in an extreme case, might entail a considerable systemic risk.

[54] Credit risks appear in the case of a default by one of the parties, market risks result from changes in the value of a transaction before it can be terminated; problems concerning setlement dates arise from a delay in the transfer of funds (e.g. in paying margin calls), liquidity risks are, in fact, linked with temporary cash-flow difficulties, etc.

In addition to the risks caused by an unsuitable institutional framework, the danger is great that, through a lack of understanding, there may be changes in the regulations which could force the local economic agents to close out their positions before maturity;

- **At the level of the commodities exchanges and of the institutions proposing over-the-counter instruments**[55]: it is also necessary to set up a supervisory organ which will enact the prudential rules and the regulatory framework and will monitor their application and their follow-up; and

- **At the level of the user companies**: a coherent internal supervision system (back office/front office) is essential for any firm wishing to use risk-management instruments. Indeed, to prevent errors[56], fraud[57] or the risk of misuse, it is essential to set up a control structure before beginning to use instruments of this kind. In a simplified way, the process of setting up such a structure can be summarized in 14 non-exhaustive points:

  - ✓ Involve senior management in the control process;
  - ✓ Introduce a system of internal and external audit;
  - ✓ Work out risk-management strategies based on the risk-reward ratio;
  - ✓ Assess the cost/benefit justification;[58]
  - ✓ Select a broker who knows his job and has a good reputation;
  - ✓ Maintain constant relations with the broker and be aware at all times of his position;
  - ✓ Establish a procedures manual;[59]
  - ✓ Inform the traders what transactions they are authorized to undertake and which are prohibited;
  - ✓ Evaluate the risk of the futures operations;

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[55] Several directives enacted by the European Union as well as an agreement concluded under the auspices of the Basel committee impose on these institutions the obligation to introduce a number of prudential rules.

[56] Such as, for instance, taking up a long position instead of a short one, choosing the wrong strike price or a wrong duration, etc.

[57] For example, capital flight, embezzlement, etc.

[58] Given, for instance, the commission costs to be paid, is it worth covering all price risks or only those necessary to prevent the bankruptcy of the firm?

[59] Describing, for example, how initial margins and margin calls should be recorded.

- ✓ Prepare detailed job descriptions for all staff;
- ✓ Adopt a clear system of authorization and approval;
- ✓ Adapt the accounting records to make them compatible with hedging activities;
- ✓ Transcribe separately brokers' transaction confirmations. It would, for instance, be useful if a separate department could prepare overviews of daily and monthly activities; and
- ✓ Identify on an ongoing basis the risks hidden by the global structure of the company's financial portfolio.

140. An appropriate control system and careful supervision are prerequisites for any enterprise of this kind.

I. Price risks

141. In chapter I, we have already highlighted the importance of this type of risk and the various instruments available to manage it. Consequently, we shall focus very briefly here on certain peculiarities which might hinder the use of such strategies.

142. The non-transfer risk, for example, is the result of a political will to delay or prevent foreign currencies from leaving the country. Firms which have activated a hedging operation will then be unable to settle their margin calls and be forced to close their positions with all the disastrous effects that follow therefrom.

143. Other barriers also deserve to be mentioned. Apart from a formal prohibition of the use of risk-management tools (as was, for instance, the case in Colombia until the early 1990s), uncertainty regarding the regulations relating to these instruments or changes in national economic policies (monetary, taxation, etc.) can not only interfere with but indeed ruin the protection efforts made.

144. It is essential to recall here that, in international trade, the magnitude of this risk is further aggravated. We shall cite but one example here to illustrate this point.

145. There are many economic agents who are forced to sell or acquire goods in advance. Exporting companies which engage in transactions of this kind, i.e. a promise to sell in the future, usually do not have the products in stock: they will have to buy them on the physical market. The main risk resides in the fact that, if the price of the item in question, as quoted by the physical markets, rises above the contractual level, the exporter will undoubtedly suffer a dead loss. Being aware of these risks, merchants may refuse to venture into such trading practices. If they do, however, their competitiveness will suffer and, as a corollary, a large proportion of their customers, used to this kind of exercise, will be tempted to abandon any trading relationship with them. They can also hold stocks of the goods, but the costs involved will often be a source of concern with respect to the company's competitive situation. Stock management in many countries - in the absence of a hedging strategy - is very often deplorable. If a company needs an operating stock equivalent to two weeks' sales (based on an average sales figure), it will generally hold a reserve of about four weeks' sales in order to be sure not to miss an important trading opportunity.

It will then be saddled with additional costs which immobilize a far from negligible proportion of its cash flow (liquidities).

146. From the end of the 1980s onwards, it has been remarked that sales of goods based on pre-established transactions but without hedging have caused the downfall of many exporting companies. Several of them have also been obliged to change their status, from that of an independent merchant to that of a dealer representing a foreign company.

J. Foreign Exchange risk

147. Fluctuations in exchange rates (and interest rates; see annex IV), a phenomenon resulting from the Jamaica Agreements[60], represent nowadays a far from negligible hazard for many trading firms.

148. When an economic agent has to make out a receivable or a debt in a foreign currency liable to change its value before the settlement date (as compared with a given reference date), he is subjected to an uncertainty that produces a foreign exchange risk.

149. The exchange risk, like that arising from fluctuations in the prices of primary commodities, has a considerable impact on the cost/benefit profile of many of a country's economic agents (e.g. an exporter buying a product in local currency and selling it in a foreign currency, a processor who imports raw materials from abroad and sells them after processing on the local market, an importer buying in a foreign currency and selling in the national currency, prefinancing accorded in a foreign currency to various domestic agents, while their profits are in local currency, etc.).

150. To illustrate this risk, let us take the case of financing economic agents in a developing country.[61] In India, for instance, drawing on the funds of a (long-term) financing arrangement in dollars provided by a development institution, many local financial establishments have given out loans in rupees. The initial terms of the credit in dollars seemed very favourable, with an interest rate of 10 per cent. At the local level, however, the devaluation of the rupee caused an explosion of this rate which, in local currency terms, became the equivalent of 23 per cent. Failure to make any assessment of the exposure to risk transformed an a priori very worthwhile operation into a fiasco.

151. In the same country, a typical example of an Indian company which obtained a dollar loan from a Swiss bank also deserves to be mentioned. Under the terms of the contract, the bank in question had the option of converting the loan into Swiss francs on maturity, a favourable interest rate being accorded, as a quid pro quo. The operation was a tempting one, but the company was running a considerable risk: while its export earnings were in dollars, it might well have to repay the loan in Swiss francs. To guard against that problem, the company had recourse to the options market. It was thus able to take advantage of financing on very favourable terms, while eliminating the potential risks involved.

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[60] Which legalized the floating of currencies in 1976.

[61] This type of financing will often be expressed in foreign currencies because the developing countries have liquidity problems which hamper the provision for many domestic needs. The cases developed here are largely taken from Jack D. Glen, How Firms in Developing Countries Manage Risk, International Finance Corporation, World Bank, Discussion Paper No. 17.

Box 13

UNCTAD's EXPERIENCE WITH RESPECT TO RISK MANAGEMENT AND COMMODITY TRADE FINANCING

UNCTAD has a programme on risk management and trade financing which plays a special role in the dissemination of the techniques and strategies to be adopted. In addition, many activities have been undertaken to contribute the technical assistance needed to establish control structures, both at the government level and at that of companies feeling the need therefor.

UNCTAD is also one of the best placed international organizations to advise government authorities on the improvements to be made at the institutional level in order to take full advantage of modern marketing and financing strategies.

UNCTAD's expertise in these matters can be briefly summed up under eight headings:

- ✓ **Integration of trade, risk management and financing of primary commodities.** Awareness-raising and dissemination of information on this concept and on the possible new strategies.
- ✓ **Problems of access to risk-management instruments and to various financing vectors.** Assistance in establishing a coherent institutional environment. Supply of the training and instructions essential for understanding them.
- ✓ **Prudential rules relating to risk-management instruments.** Advice and instruction concerning the controls needed in a company wishing to use strategies based on the use of risk-management instruments.
- ✓ **Government controls connected with the use of financial markets.** Technical assistance to set up control units in the central banks or ministries of finance.
- ✓ **Functioning of commodity exchanges.** Determination of the role of the participants such as investment funds. The assessments concerning them are mainly intended to respond to the concerns of certain economic agents who fear the disappearance of the relationship between the forward prices and the underlying prices.
- ✓ **Development of local commodity exchanges and regional futures markets.** Development of a unique expertise in evaluating the feasibility of new futures contracts and in the area of prudential rules and other suitable pragmatic conditions.
- ✓ **National stabilization agreements.** Research into the possibility of establishing regulatory structures combining the price and quantity components.
- ✓ **Structured trade financing.** Analysis of financing guarantees based on third-party holding in terms of practical conditions and institutional frameworks and of activities that could be developed to respond to the problems linked to the principles of structured financing in the primary sector.

152. In brief outline form, the underlying components of foreign exchange risk are:

- ✓ The presence of a claim or debt serving as support for the risk;
- ✓ The invoicing currency, i.e. the currency in which the claim or debt is payable; and
- ✓ Uncertainty regarding the final value as a result of variations in par value between the reference currency and the invoicing currency.

153. Once the magnitude of the exchange risk has been identified, there are several strategies that can be adopted to manage it. The economic agents can make an attempt to ensure that their short-term claims and debts coincide, at least those issued in the same currency[62], but then it is necessary to have an adequate volume of business and a certain symmetry in amounts and due dates.[63] They may also try to include a special clause in the contract stipulating that payment will be made in a certain currency and at a certain rate of exchange.[64] Many other techniques can be considered. For example, if the local currency is liable to rapid depreciation, it would be prudent to avoid borrowing in foreign currencies. By analogy, the repayment of debts can be speeded up or slowed down in the light of predictions concerning the evolution of exchange rates.

154. These processes, although they can be temporarily useful, are often difficult to apply, being out of the reach of small firms, or else they replace one risk by another. One of the most flexible risk-management strategies will, once again, be based on the use of financial instruments. Organized markets, such as the Chicago International Monetary Market, the New York Futures Exchange, the London International Financial Futures Exchange, the Singapore International Monetary Exchange, the Philadelphia Stock Exchange or the Marché à Terme International de France, offer standardized futures contracts relating to the main trading currencies. The problem arises for the developing countries which usually do not have instruments of this kind to manage operations in which there is a local currency component. It is also interesting to note that, given the individual character of these risks, many cover transactions take place on the over-the-counter markets.[65] Unfortunately, there again it will not be easy for developing-country firms to have access to these markets.

155. Lastly, there are other solutions that can be considered in some specific cases. In addition to recourse to factoring companies, which can take charge of receivables made out in foreign currencies, government institutions (often the central bank) or associated organizations (credit-insurance systems)[66] sometimes offer guarantees against monetary instability. In this last case,

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[62] A method also used by international companies is multilateral clearing based on a specified currency which will then be handled by the central treasury.

[63] A small firm could try to ensure a better equivalence between its currency earnings and its production and financing costs.

[64] The fact of invoicing in the national currency simply transfers the exchange risk to the counterparty. On a competitive market, this factor will be interpreted as a handicap. In this connection, the example of the Japanese companies, less than a third of whose exports are invoiced in yen, is revealing.

[65] At this stage, the firms considering exchange coverage will have several possible solutions:

- To seek self-coverage by placing opposite positions back to back (development of a genuine interbank market), but this strategy is mainly limited to cash transactions;
- To use swaps or the financial markets to "reinsure"; or
- To resort to alternative strategies; let us take the case of a bank which has purchased a sum of foreign currency at six months and is going to sell it immediately for cash; it has to supply the currency in 48 hours against payment in the national currency. Since it does not possess the foreign currency sum in question, it borrows it (let us suppose at 8 per cent per annum). It hands over the sum 48 hours later and receives in exchange the corresponding sum in local currency which it lends for 180 days at, say, 12 per cent per annum.

[66] The reader is referred to the presentation of COFACE activities and the example of the coffee nexus in Costa Rica below.

however, certain restrictions are frequently observed such as, for instance, limits on the duration of the exchange coverage or on the amounts to be covered. In many States, such a guarantee will take the pure and simple form of a transfer of the exchange risk to the central bank (or other State body).

156. Once again, the developing countries are at a disadvantage as compared with the industrial economies. One of the main reasons is the inconvertibility of the national currency. In addition, the institutional system and the various domestic regulations, particularly in respect of operations with foreign countries, also constitute a dominant factor.[67] Cases can even be quoted in Europe. In Spain, for example, there is a law forbidding an enterprise to write a cheque in foreign currency on its current account.[68] Ill-intentioned companies can make use of this provision to send cheques in pesetas, which are non-convertible, to their counterparties. On the morrow of the Madrid summit on monetary construction, we should mention here that, the disappearance of the European currencies should lead to the conversion of contracts drawn up in local currencies to contracts in euros and thus help to eliminate this kind of abuse. In the short term, there should be no additional risk of breach of any contracts[69] whereas, in the long term, the appearance of a single currency will provide more security and will reduce the cost of transactions.

157. At the end of the 1980s, the International Monetary Fund (IMF) published the following information concerning the developing countries:[70]

- ✓ 28 countries - 20 in Central America and the Caribbean and 8 in Africa - had a fixed but adjustable exchange rate to the United States dollar;
- ✓ 4 countries in the Arabian peninsula had limited flexibility in respect of the United States dollar;
- ✓ 29 countries had a fixed exchange rate adjustable with respect to a basket of currencies; and, lastly,
- ✓ 14 countries had opted for independent floating.

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[67] The regulations in force are often older than modern financing and payment methods.

[68] Jean-Pierre Gaertner, "Choisissez bien la monnaie de facturation", MOCI, 30 November 1995.

[69] We should emphasize that the principle of legal continuity was reaffirmed at the 1996 Dublin summit, the relevant agreements specifying that the introduction of the euro would not authorize any party to modify or cancel the terms of a contract unilaterally.

[70] Source: Gestion du risque de change (Guide No. 19), CCI, 1989.

158. However, many countries have initiated bold reforms[71]. China is a good example, the yuan becoming convertible and the reforms undertaken in the banking sector[72] constituting a step forward towards opening up the economy. The liberalization of the banking system and of interest rates which has begun at the international level will undoubtedly bring about the formation of new markets. Already the appearance of foreign exchange offices in China, active in the over-the-counter market and offering many currencies such as the Indian rupee, the Indonesian rupiah and the Thai baht, can be observed. The multiplication of forward contracts, such as that on the Mexican peso/Brazilian real which is negotiated in the Chicago Mercantile Exchange (CME), is a revealing example.

159. In short, the new boom in the development of hedging strategies,[73] which has been observed since the end of the 1980s, allied to the opening up of the developing countries' markets, gives reason to believe that identical strategies could be used in the South as well as in the North.

K. Example of a commercial chain: the coffee sector in Costa Rica[74]

160. Coffee plays a capital role in Costa Rica where it makes a major contribution to the national economy whether in terms of the area cultivated, export earnings or the contribution to GNP.[75] Fluctuations in the price of coffee and the distribution of the risks connected therewith among the various economic agents have thus a considerable impact on the entire economy. The three main groups affected by the instability of prices are the exporters, processors and producers.[76]

161. Coffee exporting is in the hands of a small group of agents (less than 30) who buy from local processors and sell to foreign coffee roasters. As a general rule, they do not hold major stocks. These agents are at the centre of the trading system in view of the fact that they often buy before undertaking to sell or, conversely, sign a sales contract before possessing the product.

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[71] To quote only one country, Ecuador has scheduled a reform of the exchange regime for 1 July 1997. In fact, the sucre will follow the example of the convertibility plan adopted by Argentina in 1991.

[72] The year 1995 was, moreover, marked by the establishment of the legislative and institutional foundation on which the financial sector is destined to develop. See, on this subject, Monetary and exchange system reforms in China, an experiment in gradualism, H. Mehran, M Quintyn, T. Nordman and B. Laurens, IMF, Occasional Paper 141, September 1996.

[73] In addition to the advances in respect of foreign currencies, forward purchases and sales are now occurring, together with currency options, swaps and warrants, not to mention currency loans, barter, clearing and exchange risk insurance.

[74] See, on this subject, Robert J. Myers, "Strategies for managing coffee price risks in Costa Rica" in Managing Commodity Price Risk in Developing Countries, Stijn Claessens and Ronald C. Duncan (ed.) (A World Bank Book, Washington, D.C., 1993).

[75] In Costa Rica, coffee is the second most important export product, employing about six per cent of the active population. The country is in the eleventh place among world producers of coffee.

[76] In addition, the consequences of an unfavourable movement of prices can bring about a serious deterioration in the national budget and harm the operations of the parastatal organizations dealing with coffee.

Although the period between the two transactions is usually quite short (less than a month), the quantities involved, and thus the risks incurred, are often considerable.[77]

162. There are two different commercial structures that coexist: private companies and processors' associations. For example, the Federation of Cooperatives of Coffee Growers (FEDECOOP) is a vertically integrated cooperative which exports about 40 per cent of the coffee for the account of the processors. Until 1989, the private companies which regularly used financial instruments for hedging had a certain competitive advantage over FEDECOOP, which had no strategy other than trying to reduce the period between delivery and export. Since then, FEDECOOP has been making use of modern marketing methods and is regularly using fixed-price strategies with its members (the processors) and "price to be fixed" strategies with the customers abroad.

163. In addition, the exporter, who by definition purchases in the national currency (colones, in this case) and sells in a foreign currency (dollars, in this case), has to face a risk that does not affect the other firms: the exchange risk. In the case which concerns us here, there are no futures contracts nor forward contracts but the central bank offers the possibility of protecting themselves to those agents who so desire. Future sales can be covered at the current exchange rate for up to one year in advance, the central bank bearing the exchange risk instead of the exporter.

164. ICAFE[78] is a statutory organ which regulates the coffee sector, controlling the domestic market through a system of quotas and determining the proportion that each processing plant can sell on the domestic market and on the export market. The processors are not subjected to a very great level of risk, since their margins and profits are strictly controlled; ICAFE desiring in this way to ensure a satisfactory price to the producers - the latter being the agents which bear the risk in question. The processors are, however, faced with certain risks arising from the following situations:

- ✓ The prefinancing accorded to the producers can be regarded as the payment of a minimum price, since there is no way in which they can be forced to repay that advance when the coffee sales would not cover it - as, for instance, happened in the case of certain firms in 1987;[79]
- ✓ If the processor, in order to avoid the risk mentioned above, fixes the prefinancing (or, for that matter, the final price) at too low a level, he exposes himself to a major counterpart risk: the producer will be tempted to sell elsewhere; and
- ✓ The processors must also borrow to prefinance the production. These loans are generally accorded by the exporter who, in his turn, must refinance himself by borrowing on the international market. The exporters can, by agreement with the

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[77] It should be noted that the margins of the coffee exporters in Costa Rica are relatively small, about 1.5 to 2.5 per cent.

[78] The Instituto del Café de Costa Rica.

[79] The average advance paid to the producer is about 60 per cent of the price received by the processor - prices thus have to fall by almost 40 per cent for the processor to suffer a loss. It is not an eventuality that can be excluded, however, since it occurred in 1986/87 and 1988/89.

processors, pass on to them a portion of the risks linked to fluctuations in interest rates and exchange rates.

165. In short, the ICAFE control system reduces the processors' level of risk but reduces their margin of manoeuvre also. Without having recourse to the futures markets to protect themselves against a fall in prices, they will not be inclined to grant a large amount of prefinancing to the producers and will thus find themselves obliged to confront a counterpart risk that would then become more and more significant.

166. The producers, who are usually small farmers growing their coffee on less than two hectares (there are, however, plantations of about 100 hectares also) usually deliver their coffee beans within 24 hours of the harvest to the warehouses administered by the processors. They are free to hand the coffee beans over to the warehouse of their choice. Investing in the production of this crop is a risky decision, since its profitability is not known since it depends on future coffee prices which are not known at the time the decision is taken. When prices fall, the producers can try to reduce costs by squeezing their inputs (fertilizers, pesticides, etc.), but the only alternative still generally remains the drastic decision to root up the coffee plants. At the first stage, they receive an initial advance (a sort of guaranteed minimum price free of every risk) which is usually not sufficient to enable them to prepare for and anticipate the next harvest. The additional remuneration will depend on the processors' performance, i.e. is accorded only if the price of the processed coffee is higher than the initial prefinancing. In short, the producer bears all the risks linked to any decline in prices.

167. At this stage, the risks have been identified together with their distribution among the country's main economic agents. The coffee sector in Costa Rica is relatively well structured, the exporters making regular use of futures instruments to cover themselves and thus benefit from a more flexible commercial approach which eliminates, or at any rate reduces, the level of risk. Even among these agents, however, the possibility of improving the terms of trade can be examined. The exporters borrow on both the domestic and the international markets. They have recourse to conventional loans in which the principal is fixed and the interest rates are revised at regular intervals. The exporters are, consequently, exposed to financial risks from the very fact that the repayment of their debts depends on their income which, in its turn, depends on the evolution of prices. If this agent's income should fall as a result of an unfavourable evolution of prices, he could have great difficulty in repaying his loan. One way of avoiding problems of this kind would be to link the servicing of the loan and/or the interest rates to the "trading performance", i.e. to price levels. To do this, it would be sufficient to take out a loan indexed on the coffee prices. In such a case, the exporter could obtain an agreement allowing him to repay his loan either by value or by quantity (of coffee).

168. If we now consider the production/processing sphere in this country, there are also and a fortiori possible improvements. Even if the processors are not genuinely subjected to risks linked with price fluctuations, they would have everything to gain by improving relations with the producer and reducing the counterpart risk. In order to do so, they should accord a relatively large initial advance while protecting themselves against the risk that the "minimum price" paid to the producer might be higher than the final price.[80]

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[80] The "final" price paid to the producer is, in fact, the price received by the processor less the processing costs and less a fixed margin of about nine per cent of the processor price.

169. The study of this specific case has made it possible for us to identify the main trading risks connected with a product the nexus of which is relatively well structured and where the country already possesses some economic agents who are accustomed to use modern management instruments. It has been demonstrated, however, that, even there, some solutions could be found which would fundamentally modify the situation. It has, for example, been demonstrated,[81] by means of simulation methods, that the use of specific strategies - based on the sale of coffee at the beginning of the harvest, the sale of forward contracts by exporters and processors or the acquisition of put options by one or other of these two agents - would have greatly reduced the risks connected with price fluctuations (the intra-annual instability risks would be reduced by 75 per cent) and even rendered possible an increase of 1.5 to 2 per cent on average in the coffee prices paid to the producers. This result would undoubtedly be even more conclusive if we were considering less advanced countries and/or nexuses that had not reached the same stage of maturity.

170. To conclude this chapter and as we have emphasized throughout this study, the risks linked to fluctuations in the prices of primary commodities, exchange rates and interest rates, constitute a definite handicap for agents who have not sufficient credit standing to enable them to speculate. In addition, the problem of counterpart risk is very relevant in view of the appearance of inexperienced agents and new trading possibilities as logical consequences of the liberalization flows and the post-Uruguay Round.

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[81] Stijn Claessens and Panos Varangis, op.cit.

III. RISKS LINKED TO THE TRANSPORT AND STORAGE LOGISTICS OF PRIMARY COMMODITIES IN THE DEVELOPING COUNTRIES

A. Introduction

171. All goods forming the subject of international trade will have to be transported from the place of production (of origin) to the place of utilization (of destination), possibly with one or more trans-shipments in well-determined places.

172. From the practical standpoint, transport is perceived as a generator of costs and of risks and needs appropriate logistics. As a general rule, the inherent risks can be insured in part but will be added to the freight rate risks and the risks connected with control problems (or default problems) during the transport process. The impact of the costs varies considerably and usually depends on the value of the goods transported and the distance to be covered. As for the logistics, the transport chain is a complex one and involves a number of intermediaries: shippers, forwarding agents, commission agents (or freight brokers), handlers, consignees, charterers, transporters (shipowners or carriers), receiving agents, warehousemen and insurers, all of whose roles and responsibilities are clearly defined.

173. As regards imports, transport costs in transit represent about 8.8 per cent of the CIF value of the goods in the case of the developing countries as against 4.4 per cent in the case of the industrialized countries. The figure is close to 22 per cent, however, for the landlocked developing countries of West Africa, 16.5 per cent for those of East Africa and 14 per cent for those of Latin America. In the case of exports, various statistical sources indicate that the cost of transport from the loading place in a landlocked country to the port of shipment represents up to 32 per cent of the FOB value and some 47 per cent of the ex works value for certain products (see annex V).

174. Like tariff barriers, transport costs can constitute an impediment to the development of the commodities trade, since they reduce the competitiveness of the producers-exporters of certain countries, particularly the landlocked ones. The extent of this phenomenon is, in fact, to be ascribed to the level of risk. Over and above the real costs, there must be added the cost of insuring against the various kinds of damage that can occur during the transportation process. The major problem which arises is that of making a correct assessment of the various risks which each economic agent has to face. (Who will bear the risk of loss or damage during the transport operation?, Who will be responsible for the customs operations?, etc.). It is possible, indeed, to imagine a whole range of ways and means of sharing out the costs, risks and responsibilities between the buyers and the sellers.

175. One of the big questions that cannot be evaded in any circumstances is that concerning liability: what will be the impact, the consequences and the parties liable in the event of a loss? The problem for many developing countries and countries with economies in transition will be not so much which modes of transport to select but rather what strategies to adopt to protect themselves against potential losses. The selection will depend not only on the costs entailed but also on the various constraints that must be taken into account. Moreover, geographical characteristics, infrastructural development and the obstacles peculiar to certain countries constitute so many factors that affect the situation of the various commercial agents.

B. Responsibilities, risks and costs

1. *The INCOTERMS*

176. Many complications (non-delivery, damage, loss, theft, misappropriation, etc.) can appear all the way along the route on which the goods are sent. These hazards will generate extra costs which must be borne by one or more of the economic agents. It is hardly surprising, therefore, that quite a number of incidents can produce disputes at law between the parties. The International Chamber of Commerce (ICC) has prepared a series of abbreviations (the INCOTERMS) which specify the reciptrocal obligations of the sellers and buyers at every link in the transport chain. The use of the INCOTERMS in contracts enables the economic agents to define their rights and obligations as regards the risks to be run, the costs to be paid or insured and the documents to be supplied. Every possibility of ambiguity or contention will thus be removed. The changes that had occurred in transportation techniques, combined with the desire to incorporate up-to-date interchange methods, led to a revision of the INCOTERMS in 1990. For practical reasons, the abbreviations mentioned above have been regrouped in four distinct categories: *group E*, whereby the buyer takes possession of the goods at the seller's own premises (the latter thus has no responsibility for transport risks); *group F*, whereby the seller's responsibility ends when the goods are delivered to a carrier; *group C*, whereby the seller has to contract for carriage but without assuming the risk of loss, damage or other costs incurred and, finally, *group D*, whereby the seller has to bear all costs and risks needed to bring the goods to the country of destination. Although a knowledge of the INCOTERMS and of their scope is a prerequisite for handling one's own costs and risks, it is not enough, however, to protect one against all the contingencies that can occur.[82] It is, consequently, essential for an agent to understand his rights

Box 14

TYPE OF TRANSPORT AND INCOTERMS 1990

Every type of transport including multimodal transport	EXW Ex works (... named place) FCA Free carrier (... named place) CPT Carriage paid to (... named place of destination) CIP Carriage and insurance paid to (...named place of destination) DAF Delivered at frontier (... named place) DDU Delivered duty unpaid (... named place of destination) DDP Delivered duty paid (... named place of destination)
Air transport	FCA Free carrier (... named place)
Rail transport	FCA Free carrier (... named place)
Transport by sea and by inland waterway	FAS Free alongside ship (... named port of shipment) FOB Free on board (... named port of shipment) CFR Cost and freight (... named port of destination) CIF Cost, insurance and freight (...named port of destination) DES Delivered ex ship (... named port of destination) DEQ Delivered ex quay (... named port of destination

Source: International Chamber of Commerce, ICC INCOTERMS 1990 and obligations, to select the most appropriate INCOTERM (best suited to his capacities, to the conditions of the market, to the results of the negotiations between the parties, etc.) and then to identify what additional risks could crop up. What is more, the use of the INCOTERMS in the contracts does not procure any right. In order to benefit from ICC arbitration, a special clause referring thereto will have to be added.

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[82] The final destination may not have been specified at the moment the contract was signed. The buyer will then have to bear an additional risk if he does not indicate the unloading place as promptly as possible. Particular difficulties also arise when the goods are placed under an export or import ban, where there are packaging problems or where there are unsuitable health rules, etc.

177. It should be specified that the INCOTERMS apply to sales contracts and do not relate to the terms[83] that can be used in the various transport contracts. They do, however, determine the framework in which the economic agents are going to have to decide what strategy is to be adopted.

2. *Transport modes and insurance*

178 The principal modes for dispatching goods at the international level are rail, road, sea, air and pipeline (for oil). The evolution of and the changes that have occurred in transport techniques have resulted in the appearance of new strategies combining several different vehicles. One of the most spectacular advances is linked to containerization which has given birth to multimodal transport, i.e. direct delivery from the point of departure to the point of arrival by combining at least two modes of transport. In addition to the time it saves, this technological revolution has resulted in a fall in handling costs and an improvement in the preservation of the goods. On the assumption that the containers respect certain rules so as to avoid any deterioration of the goods (structural strength, ease of filling and handling, etc.), the container passes from the lorry to the train and from the train to the ship in very little time and without any division of the load. Traditionally transported in bulk, commodities are nowadays more and more containerized.

(a) *International transport*

179. This phenomenon will not have a very pronounced influence as far as the type of protection that the exporter or the importer (according to the INCOTERM selected) will have to establish. For historical reasons, transport insurance terms and marine insurance terms traditionally refer to the same concepts. In fact, the rules and principles of marine insurance usually predominate in transport insurance as a whole. The expression marine insurance usually includes protection against loss and damage of both the ship's hull and the goods transported as cargo.

180. Transport risks are usually classified in three sub-groups:

- ✓ The first relates to particular average: material injury, loss of weight or deterioration of quality suffered by the produce.[84] These occur irrespective of the transport mode and the only agent to run this risk will be the consignor, or rather the custodian, of the goods (unlike the case of general average, where the responsibility is shared).

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[83] There are, however, similar terms which govern charter parties.

[84] Insurance against the risks of loss of weight or deterioration in quality during transport is a crucial factor in the primary sector. Coffee, for instance, according to the way it is cleaned, fermented or dried, will have a humidity rate of 12 to 15 per cent (and sometimes higher) which will inevitably cause variations in weight during the transport operation.

✓ The second, relating to general average, concerns solely the risks specific to carriage by sea.[85] These risks are shared between the shipowner and the consignor/custodian of the goods;

✓ The third relates to exceptional events such as wars, riots, strikes, sabotage, acts of terrorism, etc.

181. As a general rule, an insurance contract will cover all the risks that can occur during the transport chain. Care must always be taken, however, to examine what limits to cover and what exceptions are contained in the contract. For example, delays can occur (due to hold-ups in the customs or other formalities) which will result in the contractual period being exceeded. In the absence of a special clause, the goods will no longer be insured. There are some factors that can also result in the invalidation of the insurance policy. It may be a question of a deliberate fault of the insured party such as poor packaging or an attempted fraud[86], etc.

Box 15

THE OBJECT AND EFFECTS OF THE INSURANCE

Insurance of the fault: covers the carrier's liability. His role is to deliver the goods undamaged. In order to do so, he is obliged to satisfy himself concerning the state of his vehicle, guarantee the good dispatch of his load (including any trans-shipment) and issue and supply the necessary documents (receipt on board, bills of lading, etc.) In respect of the inherent risks, certain limitations can, however, be observed and the shipper will then be liable for the potential losses. In short, in the event of a disaster, the carrier (or his insurer) will be liable for only part of the loss, unless he has committed a serious fault, or else in a case of wilful misrepresentation of a declaration of value or of special interest in the delivery.

Insurance of the property: protects the cargo (load) against any losses averages or delays that may occur. This insurance complements that of the fault, since it covers the limitations of the carrier's liability.

182. Whatever the mode of transport used, there are four types of insurance policy:[87]

✓ The "for the journey" policy covers exceptional shipments;

✓ The "declaration" policy covers a series of shipments of goods of the same nature to a specific market;

✓ The "floating" policy covers all the shipper's consignments during a given period; and

✓ The "third-party shipper" policy which is taken out by the carrier for the account of his customer. It is not automatic and usually covers a particular shipment.

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[85] That is, action to save both the ship and its cargo.

[86] Fraud generally proceeds from the falsification of transport documents when trading operations are based on a documentary credit. The example of Nigeria, where the frauds that have seen the light of day since 1989 in the marketing of crude oil are getting bigger and bigger, may be quoted here.

[87] See, on this subject, Catherine Batteux, "Sachez maitriser l'assurance transport", MOCI Nos. 1282-1284, 1-8 May 1997.

(b) *Domestic transport in the developing countries*

183. The vast majority of the goods transported by sea or by air are insured. On the other hand, there is no insurance in rail transport, the carrier being his own insurer. As for road transport, it is rather problematic: the shipper usually thinks he can claim from the carrier in the event of a loss, being unaware that, in most cases, the latter will be exonerated from his liability by force majeure.

184. As a general rule, the risk of deviation, theft, piracy, etc. is greater in the developing countries. A gang of pirates, for instance, diverted almost $20 million of cargo to the Philippines in 1991. The risks are still greater if the country has no coastline, or for inland transport in general. In Singapore or Romania, as between Hong Kong and the rest of China, the number of thefts and misappropriations in the course of inland transport is growing constantly, entailing a steep increase in insurance premiums and sometimes even the withdrawal of some insurance companies.

185. As a result of this fact, the shipping of commodities, whether imports or exports, is riskier for the landlocked countries than for the coastal countries. Most losses and cases of damage occur on the inland journey. The insurers who agree to guarantee local transport will thus require a fairly high premium. In some cases, there may not be any insurance available at all, thus making prefinancing operations difficult if not impossible.

186. The condition of the harbour infrastructure, combined with the insecurity prevailing there, will cause foreign insurers to hesitate to underwrite a coverage based on the "warehouse to warehouse" clause.

187. In view of the limited amount of their business, the local insurers who have the opportunity will be obliged to quote higher rates than the foreign insurers. They will often have to cover themselves in their turn by taking out reinsurance abroad, with the resultant heavy expenditure in foreign currencies.

188. What is more, the local companies do not usually have sufficiently skilled staff (inspectors and experts). Delays will thus occur in settling claims, entailing frequent disputes and contributing still more to the general insecurity.

189. In addition to improvements in the transit infrastructure, services and formalities, security could be increased by reforming the insurance schemes and in particular by:

- ✓ Abolishing, wherever possible, restriction on the choice of insurers;
- ✓ Increasing the scope of the reinsurance coverage with international companies; and
- ✓ Making the carriers and warehousemen responsible for delivering the goods entrusted to them.

C. Importance of the documents used

190. As well as the contracts specific to the very use of the mode of transport (such as references to freight cover notes or chartering contracts in marine transport), there are some additional documents. They concern more particularly the goods. They are usually issued by the carrier or his authorized agent and refer to the quality of the product and the title of ownership thereof. The

most usual documents are the bill of lading[88] in marine transport, the consignment note for land transport and the air waybill. A number of other documents exist and are required to jusify the shipment of the goods or their customs transit, for instance. The most common ones are the delivery note, the mate's receipt on board, the surety bond, the consular invoice, the customs invoice, etc.[89]

191. The contract of carriage is usually regarded as a consensual agreement. However, the documents used, and particularly the way they are drawn up, have a considerable role to play. This is a decisive moment since it will determine the level of responsibility of the various economic agents. The possibility will then arise of legal disputes concerning commodity trade and financing. By way of illustration, two aspects can be briefly consiidered here:

- ✓ Some reservations can be entered in one of the documents. Comments regarding the quality or quantity of the primary commodities transported can be made: in the event of a disagreement, the transport documents must be clean, ie. have no reservations at the start of the journey[90]. If not, that means that the carrier declines all liability with regard to potential defects;

- ✓ A mistake in the formulation of the documents can result in heavy losses. The inherent risk of non-payment may be significant. Let us take here the example of a documentary credit between an exporter and an importer. The exporter is to be paid by a bank that will examine only the documents submitted to it and not the product itself. Any blemish found in one of the documents can entail a risk of non-payment or of considerable delay in payment. Many cases can be cited, such as the fact of not supplying the weight in the required unit, mispelling the name of a place or person or even submitting a document with something crossed out in it. In an extreme case, the omission of a comma could constitute a sufficient circumstance.

192. The first example highlights the responsibilities in the case of a claim and the importance of the documents drawn up and the terms used. In some circumstances, the risk of noting a decline in quality, a fall in weight, etc. cannot be blamed on the carrier. The second reveals the possible risks of faults which are due to carelessness or to ignorance of the consequences that can follow from the drafting of these documents. The problems arising from carelessness can be resolved by stricter checking while those related to ignorance can be rectified by the adoption of some standardized rules and by appropriate training.

193. It may be useful at this stage to point out that there are some conventions in existence concerning international transport. They clarify the approaches to be adopted and enable the

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[88] This document in fact fulfils three essential functions. It proves that the goods have been delivered, certifies the presence of the contract or carriage and enables rights to the goods to be transferred during the transport. It is thus a negotiable document.

[89] According to the product considered, other certificates relating not specifically to the transport but to the product itself will also be needed, such as certificates of weight, quality, fumigation, origin, etc.

[90] Article 32 of the UCP 500 states that "A clean transport document is one which bears no superimposed clause or notation which expressly declares a defective condition of the goods and/or the packaging." However, clauses of the "shipper's load and count" or "said by shipper to contain" type are not regarded as reservations in the context of the UCP 500.

existing laws and regulations to be harmonized.[91] Moreover, they usually have an almost supranational character, national laws being applied only in an auxiliary way. The Brussels Convention, for example, was elaborated for application in a documentary context.

Table 3

Brief outline of some of the conventions governing international transport

Mode of transport	Rules and conventions governing international transport
Maritime transport	The Brussels Convention (of 1924), particularly The Hague Rules, for the unification of certain rules relating to bills of lading. The Hamburg Rules (1978) apply to every contract (they also deal with questions relating to bills of lading; they are, however, more exacting than The Hague Rules)
Surface transport	*Road transport*: Geneva Convention (CMR) of 1956. *Rail transport*: Bern Convention (CIR) of 1980.
Air transport	Warsaw Convention of 1929 (no distinction between domestic and international traffic); together with The Hague Protocol to the Warsaw Convention and the Guadalajara Convention and Protocol
Multimodal transport	United Nations Convention on International Multimodal Transport of Goods, 1980

D. Freight rates

194. If we consider maritime transport, which is in fact the method most commonly used to convey primary commodities in the international sphere,[92] there are two main modes that can be used.

✓ ***The liner conferences*** propose harmonized tariffs and usually specialize in containerization. A liner conference is , in fact, a grouping that proposes fixed rates and conditions known in advance (i.e. no surprises). The rates can be determined in accordance with several methods.[93] The most widespread is based on a calculation in terms of the weight or the volume of the goods carried. Formulas can also be used which take account of the type rather than the quantity of the products - a lump-sum price will then usually be proposed.

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[91] The 101 rules of the United Nations Convention on Contracts for the International Sale of Goods can be quoted as an example. Articles 66 to 70, making up chapter IV on the passing of risk, can constitute a useful legal reference in some cases. Articles 85 to 88, on the preservation of the goods, may also prove useful.

[92] Except, of course, for perishable goods such as horticultural produce which must usually be carried by air. We should, perhaps, emphasize here that, with the appearance of multimodal (door to door) transport, the overland transfers to and from the ship cannot be governed by the maritime conference agreements. That is, in fact, what is specified by European Union regulation No. 4056/86 which provides that users must be able at any moment to make themselves acquainted with the prices and conditions of transport practised by the members of the conference on the understanding that land transport organized by the maritime carriers remains subject to regulation No. 1017/60.

[93] One of the main present-day aspects of the liner conferences is linked to the debate regarding maritime competition, particularly with respect to the possible abuse of dominant positions or price discrimination. The European Union decisions in this area (cf., for example the TAA and FEFC cases and the case of the Franco-West African

✓ *Non-conference services* which group either small local carriers or large shipowners who are trying to act on their own and compete with the conferences. In general, no specific price tariff is proposed. The rates vary according to supply and demand. It is thus possible to negotiate transport terms.

195. However this may be, the liner conference tariffs are normally standardized and can thus be consulted by all and sundry. Certain qualifications may nevertheless be applied in the event of overload or if the product has been packaged in a particular way.

196. Freight-cost risks will thus relate more particularly to non-conference services. To protect himself, the trader can negotiate with a shipowner a global quantity over a determined route for a fixed duration. He can also try to acquire an option which will give him the right to pay a given basic premium if prices rise (he will then exercise his right) or else abandon the right and ship more cheaply on the market if prices fall.

197. It is worth mentioning here the existence of a futures market, the BIFFEX[94], which deals in freight rates. This market is located in London and quotes rates for various regions of the world (11 in all). The freight rates for each route are communicated daily by special groups of transport brokers and are then converted into an index known as the Baltic Freight Index.

198. In short, it is important to recall that, even if the liner conferences propose a tariff determined in advance and thus less risky,[95] they do not exist everywhere (in West Africa they have been virtually broken up) and can be synonymous with monopolies.[96] What is more, to avoid the various risks of fraud and diversion, UNCTAD prepared in 1988 a list of minimum conditions required for a person to be approved as a steamship agent. This list can, in fact, be used by public organizations or professional associations to enact the national conditions to be adopted to avoid this kind of risk.

Shipowners' Committees and CEWAL) illustrate this phenomenon perfectly. It suffices to consider the situation on the Europe-West Africa service to observe the major changes that are occurring; the supply of maritime transport is passing from a structure monopolized by the liner conferences to a system governed by independent operators. The shares of the market are still very unequal, however, with five companies controlling more than 80 per cent of the transport capacity in service.

[94] Baltic International Freight Futures Exchange.

[95] They can offer more advantageous terms (stabilization role ensured by the concession of a uniform level of freight rates, a regular and punctual service, economy of scale - on the Europe/Asia market, for example, a weekly service offered by a consortium arrangement requires the operation of five container ships as against nine if the shipowners were independent, etc.)

[96] It is, however, worth noting that, in 1974, UNCTAD drafted a Code of Conduct for Liner Conferences, which was ratified by a number of countries in 1983. This code aims at supervising the operation of the conferences so as to prevent abuses and guarantee the participation of the national merchant fleets of the developing countries on the basis of a principle of market shares fixed in advance.

199. In the case of inland transport, no specific rule seems to exist in reality, transport costs being determined on a case-by-case basis after negotiation.

E. State of the infrastructure in the developing countries

200. One of the stumbling blocks to transport and storage - and indirectly to trading and financing in the primary sector - will be the degree of infrastructural development. Since primary commodities are often perishable products,[97] transport times constitute a far from negligible risk. Moreover, according to the geographical situation, certain routes will be less practicable or offer less security than others. Lastly, the dilatoriness that can sometimes be observed will in fact mean, in financial terms, an opportunity cost.[98]

201. The landlocked developing countries will be at a major disadvantage. They depend on the goodwill of their neighbours for access to the sea. The journey is longer and riskier and thus more expensive. On the whole, there are still many problems to resolve. Certain networks exist, however, warehouses can be used and there are lines of communication that can be exploited. Despite many difficulties, the existing resources can sometimes be used. It is a matter, therefore, of taking advantage of and, to some extent, strengthening the existing structures. One of the difficulties will be to identify and select the resources suited to each country, particularly those which could be used in the trade and the structured financing of the primary sector. This subject will not be discussed in greater detail in the present study.

Box 16

TRANSIT PROBLEMS IN LANDLOCKED DEVELOPING COUNTRIES

For a number of years, now, the landlocked developing countries and their transit neighbours have been trying hard to improve the transport systems on the national, subregional and regional scales.

The degree of effectiveness depends on the political will to promote the conclusion of cooperation agreements between the landlocked countries and their neighbours and on the institutional capacity to implement the programmes agreed upon in this sector.

In the framework of its technical cooperation activities - and taking into account the repercussions of the prohibitive transport costs on the development of the landlocked countries - UNCTAD has, for example, developed three subregional projects to improve transit conditions in southern Africa, Central and East Africa and Central and West Africa. Suitable activities have encouraged relations with various financing organizations which are committed to helping the landlocked developing countries.

202. This section will concentrate on the present situation in a number of countries to reveal the particular obstacles and the various inherent risks. As an example, we shall present briefly here a sketch of the state of the infrastructure (roads, railways, warehouses, etc.) in the continent of Africa, particularly in the subregions of West Africa and Central Africa. Like Latin America, Asia or Eastern Europe, Africa constitutes a revealing example of the problems intrinsic to the developing countries and the countries with economies in transition.

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[97] Or products whose quality will suffer if the transport is not carried out in good conditions.

[98] In the absence of any collateral certificate (e.g. letter of third-party holding), the transport and storage will mean the immobilization of the products for the duration of the time required and thus constitute an opportunity cost to be borne by the exporter, if he has not yet been paid, or by the importer if he has agreed to an advance.

West and Central Africa[99]

203. The subregions of West Africa and Central Africa have relatively heterogeneous infrastructures. Despite the existence of nine main transit zones having a range of more or less adequate port installations and services, there are five landlocked countries.

204. **Mali** is, despite the presence of the river Niger, a country hemmed in by seven others. Three major transit routes can be enumerated: the Bamako-Dakar railway, the road link to Abidjan and the road link to the port of Lomé.[100] On the Abidjan highway, transport encounters numerous non-material obstacles which delay the movement of the goods and increase the cost of the transit operations. As for the storage installations, in addition to the "cereal banks" the Government of Mali has established warehouses at Dakar, Abidjan and Lomé. The forwarding agents say that the procedures for the dispatch of goods by rail from Senegal to Bamako are effective. The length of time that Malian goods remain in Abidjan has apparently been reduced from 90 days to 15 days. As for customs clearance, it varies from two days to a week (there is, however, an accelerated procedure).

205. **Burkina Faso** is also a landlocked country. It is currently using three major transit routes: the Ouagadougou - Bobo Dioulasso - Abidjan railway, the road linking the same towns and the Ouagadougou-Lomé highway. There are no capacity problems, but capital investment would be needed for certain types of installation (such as container terminals and warehouses). Containerized traffic is developing and Abidjan would be the port best equipped to receive it. Customs delays can vary from 48 hours for perishable produce to two weeks for other products.

206. **Niger**, a landlocked country, also has three major transit routes: the Cotonou-Parakou railway, the road through Niamey and the Lomé-Koupéla-Niamey highway, and the link to Lagos via Sokoto.

207. **Chad** depends on the ports of the neighbouring countries, particularly those of Douala, Port Harcourt, Lomé and Port Sudan. Since the railway is virtually non-existent, the road network is the only possible way of transporting goods. Despite a fairly short customs clearance period (about three to four days), the dispatch period is often prolonged because of delays in the port of Douala.

208. **The Central African Republic** is the fifth landlocked country of the area. It is served by two great lines of communication: water transport on the Ubangi river, which links Bangui to the port of Pointe-Noire via Brazzaville[101] and the road[102] and rail connections that link it to Douala. The average customs clearance period is five to six days. The movement of goods is, however, hindered by the need for vehicles to travel under escort.

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[99] We shall not deal here with air transport, since it does not constitute a significant percentage of the carriage of commodities.

[100] Mali has one of the poorest road networks in West Africa.

[101] Brazzaville-Pointe-Noire is carried out by rail. Despite the age of the river fleet, this mode of transport is still much used. Indeed, the European Union granted in 1994 a sum of CFAF seven billion for its renewal.

[102] It should be noted, however, that the road infrastructures, which are in constant use in the country, become more dilapidated every day.

Box 17

CUSTOMS DUTIES

One of the traditional barriers to trade is the existence of prohibitive customs tariffs. In fact, the obstacle is tending to diminish, particularly since the conclusion of the Marrakesh Agreement and the appearance of new regional zones. Western and Central Africa constitute a good example of integration in that regard.

The West African Economic and Monetary Union consists of Benin, Burkina Faso, Côte d'Ivoire, Mali, Niger, Senegal and Togo. It has set itself the target of abolishing all customs duties by January 1998.

UDEAC is the Customs and Economic Union of Central Africa. It consists of Cameroon, Congo, Gabon, Equatorial Guinea, Central African Republic and Chad. This zone is governed by a common external tariff (CET) which defines four categories of products, primary commodities being taxed at 10 per cent. Within UDEAC, a preferential tariff applies until the end of 1997, after which goods should circulate freely.

209. **Cameroon** is a transit country and has five ports: Douala-Bonabéri, Kribi, Limbé, Tiko and Garoua. Douala-Bonabéri alone accounts for 97 per cent of the trade flows. It should, however, be mentioned that this last port has to cope with a serious technical drawback: the draught is seven metres, which renders international traffic difficult and/or entails considerable extra costs for dredging. The road network is essentially made up of dirt tracks. There are two main railway lines, the Transcameroon - Douala-Yaoundé-Nagaoundéré (with the Ngoumou-Mbalmayo branch line) and the Douala-Nkongsamba line (with the Mbanga-Kumba branch). Customs clearance at the sea ports takes 15 to 20 days. Several customs-free zones were established in 1990, in which are grouped processing companies active in the wood, cacao, palm-oil, coffee and cotton sectors.

210. **The Congo** has only a single port, that of Pointe-Noire. Despite coordination between the railway, river and maritime networks, the condition of the infrastructure is deteriorating. Consequently, competitiveness is on the wane as compared, for example, with the Democratic Republic of the Congo. The average period of customs clearance is 10 days, and there are no accelerated procedures.

211. **The Côte d'Ivoire**, with its two ports of Abidjan and San Pedro, can be regarded as the heart of its subregion. Its installations are of good quality and access is easy. Its road network is one of the most developed, is improving daily and accounts for more than 97 per cent of the total domestic trade. On the other hand, the railway network is not in very good condition and only the line from Abidjan to Ouagadougou is usable. With the existing harbour installations, about 10 million tons of goods can be handled annually. The duration of transit is, however, long and this reduces the competitiveness of the Côte d'Ivoire vis-à-vis its neighbours (ports of Lomé, Dakar or Cotonou). Moreover, the average period of customs clearance is 10 to 15 days.

212. **Gabon**. Libreville-Owendo is a harbour complex which includes a commercial port, a timber-lorry port and an ore-ship port.[103] There is also another port area - Port Gentil - where timber and fuels are mainly loaded. The road infrastructure is little developed because of the characteristic geographical features (forests, swamps, etc.). The two main highways are a north/south axis linking Cameroon to the Congo and a west-east one in the direction of the Congo. The transgabon is the main line, linking Owendo to Franceville. The Compagnie de Navigation Intérieure is engaged in water transport on the Ogooué river, with some competition from private individuals. Despite the fact that customs clearance can be carried out in a single day, the

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[103] The Elf Gabon company has its own private oil terminal.

inadequacy of the port superstructures, combined with certain inland connection difficulties, results in long waiting periods (and thus in high opportunity costs).

213. **Guinea** has two ports of Conakry and Komsar. The road network is limited to four main highways which criss-cross the country. Customs clearance takes one to two weeks.

214. **Equatorial Guinea** also has two ports: Malabo, where warehousing is impossible because of saturation by oil traffic, and Bata. Despite an extensive road network, only two highways are still in good condition, namely, the road between Neue and Mongomo and the link between Malabo and the airport.

215. **Senegal** has an effective transport network since it has the second biggest port in West Africa, after Abidjan. Dakar handles about 3.5 million tons of goods per annum and possesses relatively modern installations. The road network is also well developed and much maintenance is being carried out. There are eight main highways. On the other hand, only two railway lines cross the country. Customs clearance takes about a week, but there are accelerated procedures.

East Africa

216. The transit routes used by Burundi, Rwanda and Uganda are centred upon the ports of Mombasa and Dar-es-Salaam. It is important to emphasize that a single road transit document is needed to dispatch goods through the corridor linking Mombassa to Uganda, Rwanda and Burundi. In the central corridor linking the landlocked countries to the port of Dar-es-Salaam, goods in transit are carried under cover of a transit certificate. This latter is cancelled when the containers leave Tanzania without being opened or inspected in Dar-es-Salaam.

Southern Africa

217. This subregion has six landlocked countries: Botswana, Lesotho, Malawi, Swaziland, Zambia and Zimbabwe. The ports used for transit are those of South Africa (Durban, Richard's Bay, Port Elizabeth and Cape Town), Mozambique (Maputo, Nacala and Beira), Tanzania (Dar-es-Salaam) and Angola (Lobito).

218. To conclude this chapter, we may simply recall that the terms used in drawing up contracts (whether of sale, insurance or carriage) will entail the appearance of various risks that should be known. When an exporting company in a developing country wishes, for instance, to sell its produce CIF rather than FOB, and thus receive a higher proportion of the final price, some additional risks of a varied nature will appear. In the case of exporters from landlocked countries, the risk is all the greater in that there is not only the maritime transport but also the overland transport and the high cost of insurance (if it is available) to be taken into account. Finally, it is not so easy to export as far as the country of destination since these products have to take the long and often tortuous path of marketing and avoid the physical and administrative obstacles that they will encounter all the way along the nexus. Solutions exist, however, and the traps can be evaded by adopting judicious and suitable strategies.

CONCLUSIONS

219. The trading firms, processing industries and exporters from the developing countries are exposed to considerable degrees of risk as compared with their opposite numbers in the industrialized countries. What is more, they do not always have a very favourable institutional environment and have less possibilities of managing the risks they encounter. The additional inherent costs with which these agents are saddled are considerable; the total cost must surely represent several percentage points of current export earnings. The international companies trading with these firms also run many risks (sovereign risk, counterpart risk, price risk, exchange risk, etc.).

220. Most of the current debates and discussions relating to the marketing of goods focus on tariff and non-tariff barriers. Despite the fact that this question is inescapable, it has been established in this study that poor risk management not only entails an additional burden but also greatly reduces competitiveness. Action to try and remove these obstacles is far from systematic, however, and most of the development agencies do not in practice deal with this problem to any genuine extent.

221. The international environment has changed profoundly. The Marrakesh Agreement has created, like the fall of the Berlin Wall, a new "economic-politico-social" context. Novice commercial agents have emerged in the developing countries, intensifying still further the trading risks and costs. The risk profile of the trade in commodities can, however, be improved through speciric actions and programmes such as those undertaken by UNCTAD. The development of risk management can be achieved directly, through the improvement of information, transport and storage systems, and indirectly by the adoption of appropriate strategies (management of price and exchange risks, insurance, third-party holding and documentary credits), but also reform of the institutional environment, infrastructure and the like.

222. By fully controlling their operations, the economic agents will gain in terms of security, effectiveness and profitability. The purpose of this study is not to trumpet the merits of out-and-out protection or paralyse the commercial nexus but to obtain a thorough understanding of the potential hazards inherent in the production and financing of and trade in commodities. At the end of this first stage, the firms should be able to identify, and thus classify in order of importance, the main risks to which they are exposed. Finally, it should be possible for them to select the most appropriate strategy or strategies to initiate a programme suited to managing the risks, while avoiding any bankruptcy. Some of these criteria may appear antagonistic but, since the risk factor is at the heart of this approach, the ambivalence will, in fact, be apparent only. This principle is well and truly basic to the strategies that have been developed for risk management and structured financing operations. These methods are not the prerogative of the elect few, they should rather be examined attentatively by all the developing-country agents finding themselves in a situation where any error of assessment could be disastrous.

223. In addition to the "increasing awareness" aspect, this study also endeavours to present some "tracks to be explored" to encourage the establishment of structures suited to preventing the various virual difficulties. Indeed, a number of programmes, agreements and conventions have the purpose of assisting the economic actors who feel the need therefor. It will suffice to identify those which would best respond to their requirements.

224 In outline, the message that we have tried to eleaborate here in respect of the risks/costs ratio can be boiled down to three formulas:

- ✓ Understand,
- ✓ Identify, and
- ✓ Manage.

"Risk management has a broader social aspect, as it leads to reduction in wastage of economic resources and prevents environmental degradation"[104].

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[104] Gallis-Quedraave, in "Promotion of risk management education and practices in developing countries", paper submitted to an international symposium on risk management in Japan (November 1991).

Annex I

MAIN CREDIT-INSURANCE COMPANIES: THEIR STRUCTURES AND THE SERVICES THEY PROPOSE: THE EXAMPLE OF SOME SELECTED COUNTRIES

This annex may serve as an example for certain countries, particularly developing countries, which might wish to set up a credit-insurance system to cover and finance trading operations. Consideration may be given to the selected and illustrated programmes and examples of structure may even be used as models. The data compared in this table are based on the publications cited below and on information released by the industry. It should be noted here that, within the context of its activities, UNCTAD has made an analysis of the various organizations and services available in the developing countries, an analysis that was summarized in the report "Review of progress in trade-finance facilities of developing countries at the interregional, regional and subregional levels" (UNCTAD/ECDC/254) of 22 March 1996.

Country	**Insurance company**	**Description**
Germany	Hermes (a consortium made up of Hermes Kreditversicheung AG and Treuarbeit Wirtschaftsprufungsgesellschaft)	This consortium can be likened to the secular arm of the Government. Political, monetary, natural-disaster and commercial risks are insured. The standing interministerial committee for credit insurance (IMA) is the decision-making organ. Export financing is insured mainly by AKA (a consortium of 43 German banks), KFW and the commercial banks.
Austria	ÖKB (Öesterreichische Kontrollbank Aktiengesellschaft)	The Austrian system constitutes an example in itself. Export financing is not subsidized at all. The solution lies in the fact that refinancing is carried out in schillings, a currency having a relatively low rate of interest, and ÖKB can refinance itself (its main financial backers bring the commercial banks) on the basis of a structure in which one part of the interest rate is fixed and the other fluctuates: the relationship being adjusted every quarter. ÖKB also supplies a range of commercial services to the Austrian commercial banks.
Belgium	OND (Office National du Ducroire) Creditexport	OND supplies medium-term export credits for operations costing at least 35 million Belgian francs, based on a minimum two-year period. OND covers political, natural-disaster and monetary risks as well as commercial risks for operations directed to non-European countries. In addition, it reinsures half the commercial risks covered by a private company: the Compagnie Belge d'Assurance Crédit. Creditexport is a non-commercial organization whose budget is financed to the extent of 44.5 per cent by the public sector, the rest being covered by the main commercial banks.
Denmark	EKR (Eksportkredit, a company set up by the Ministry of Industry)	The non-negotiable risks should be covered by a special government fund, the Danish Trade Fund. EKR offers a credit-insurance policy which protects the policy-holder for two years.

Spain	CESCE (Compañía Española de Seguros de Crédito a la Exportación)	This official export-credit and insurance system depends in fact on three different institutions. Insurance is provided by the Compañía Española de Seguros de Crédito a la Exportación (CESCE). Some private companies can also offer coverage of commercial and political risks, but CESCE is the only one that covers, for the account of the State, non-negotiable commercial risks and extraordinary political risks. Financing is provided by the commercial banks, particularly the Banco Exterior de España (BEE). Incidentally, this bank is able to approach El Instituto de Crédito Oficial (ICE) to obtain additional funds.
Finland	FGB (Valiontakuukeskus or Finnish Guarantee Board)	This organ promotes exports and supports small and medium-sized enterprises by offering export credits and government guarantees. The main insurance policy - known as L-Guarantees - covers exporters against political and commercial risks.
	FEC (Finnish Export Credit)	This is a public institution which finances Finnish companies and their domestic and international counterparties. The loans granted relate mainly to the commercial sectors, capital goods and services which need medium- to long-term financing. The loans are made on a commercial basis (FEC is very dependent on the international market) and provide a wide range of possibilities.
France	COFACE (Compagnie Française d'Assurance pour le Commerce Extérieur)	COFACE is mainly owned by banks and insurance companies and offers protection against exchange risks, counterpart risks, sovereign risk and so forth (see box 10). For the Euler/SFAC group, see para. 122).
United Kingdom	ECGD (Export Credits Guarantee Department) ISG/NCM (Insurance Services Group) - ISG, which used to be responsible for short-term operations within ECGD, was sold to NCM in 1991.	ECGD, a public entity, covers British exports to more than 130 countries, guaranteeing more than 130 million worth in the last three years. ECGD usually offers an export insurance policy which covers up to 90 per cent of the commercial and political risks. In addition, it supplies buyers' credits (unconditional guarantees to banks covering purchases of British goods and services), export credit lines, protection against exchange risk, project financing and an insurance policy supporting investments abroad. Short-term export credit insurance (consumer products) is completely privatized - ISG/NCM.
Greece	ECIO (Export Credit Insurance Organization	ECIO offers insurance against political, commercial and other risks and reinsurance of commercial risks. It is possible to cover all such transactions or merely certain specific contracts. Private insurance companies also cover commercial risks and reinsure with ECIO.

Italy	INA (Istituto Nazionale delle Assicurazioni) SACE (Sezione Speciale per l'Assicurazione del Credito all' Exportazione)	INA, a public institution, supplies protection to Italian exporters, the ultimate guarantee being provided by the Government. It intervenes in the management of export-credit insurance by offering guarantees and by reinsuring private companies. SACE can cover risks arising from war, riots, earthquakes, a moratorium and force majeure as well as transfer risks and commercial risks. Mediocredito (Istituto Centrale per il Credito Medio), a medium- and long-term credit organization, refinances various domestic and international operations on advantageous terms.
Ireland	ICI (The Insurance Corporation of Ireland)	Following the takeover of this insurance company by AGF (Assurances Générales de France), ICI decided to cover commercial risks. The Irish Government continues to insure political risks and medium-term risks. ICI also offers protection against insolvency and against problems connected with the sale of goods or services which entail the non-repayment of short-term loans (180 days).
Luxembourg	ODL (Office du Ducroire)	Exports are financed either by the commercial banks or by public banks, whereas at the credit-insurance level, the private sector proposes support only for short-term operations. ODL covers the political and commercial risks.
Norway	GIEK (Norwegian Guarantee Institute for Export-Credit) and Eksportfinans (Financing and Export Credit Institute of the Norwegian commercial banks)	These two institutes offer possibilities of financing and insurance to Norwegian exporters.
Netherlands	NCM (Nederlandsche Credietverzekering Maatschappijune) a subsidiary of NCM Holding NV	NCM, the leader of the privatized companies, offers domestic and export insurance and possibilities of reinsurance for other companies. Coverage of commercial, monetary, natural-disaster and other risks is underwritten on behalf of the Dutch Government, and is renewable every three years.
Sweden	SEK (Svensk Exportkredit)	There are two institutions which coexist; the Swedish Export Credits Guarantee Board, Exportkreditnamnden (EKN) and the Swedish Export Credit Corporation, Svensk Exportkredit (SEK); and supply almost all the medium- and long-term financing at fixed-interest rates.
Switzerland	ERG (Geschäftsstelle für die Exportrisikogarantie)	ERG covers political risks (war, revolution, etc.), transfer risks, commercial risks (when the purchaser or the guarantor is a public entity) and pre-dispatch risk. There is no public involvement in the financing of Swiss exports.

United States of America	EXIMBANK (Export Import Bank of the United States) - an independent government agency	PEFCO (the Private Export Funding Corporation) is the organ that finances United States exports. This company, which is owned by various commercial banks, industries and financial corporations, offers loans at fixed rates (medium- and long-term) to foreign economic agents when there is no possibility of obtaining them on the market. EXIMBANK operates in collaboration with the Foreign Credit Insurance Association, which is made up of more than 65 private insurance companies. It insures short-term (less than six months) credit risks and medium-term credit of less than five years.
Canada	EDC (Export Development Corporation), owned by the Government	EDC helps trade and investment abroad. To do so, it supplies the means of managing risks by offering credits and insurance policies to Canadian companies. The insurance programme covers, in principle, 90 per cent of the contract value, the remainder being borne by the exporter.
Argentina	CASCE (Compañía Argentina de Seguros de Crédito a la Exportación S.A.) and Aseguradora de Créditos y Garantías	CASCE, established in 1967, is controlled by several insurance companies and offers protection against commercial risks and, on behalf of the Government, against political and natural-disaster risks. Asegurados de Créditos y Garantías, a private company active in domestic and export credit insurance, offers in particular a short-term coverage against commercial risks.
Barbados	Export Credit Insurance and Guarantee Department	Under the auspices of the central bank, insurance is offered against commercial (including pre-dispatch) and political risks.
Brazil	PROEX (Export financing programme)	PROEX is managed by the Banco do Brasil, the Government's financial organization. The main international banks (and other institutions) finance Brazilian exports and the Federal Government guarantees them an annual interest rate varying from 1 to 3.5 per cent, according to the contractual modalities. In 1997, a private credit-insurance company was established. It is principally owned by the commercial banks and insurance companies, in partnership with COFACE, which supplies the necessary technical assistance.
Chile	Compañía de Seguros de Créditos Continental S.A.	This company is active in domestic and export credit insurance. It covers commercial risks, bankruptcy and default, up to 70 per cent and 80 per cent respectively.
Colombia	Segurexpo de Colombia S.A. (Aseguradora de Comercio Exterior)	Owned by insurance companies and banks, Segurexpo offers coverage against commercial risks (to an extent of 90 per cent) and, on behalf of the public sector, against political and extraordinary risks (85 per cent).
Costa Rica	INS (Instituto Nacional de Seguros)	Managed by the maritime department of INS, it covers commercial risks (bankruptcy and default)

Jamaica	EXCICO - Jamaica Eximbank (National Export Import Bank of Jamaica)	This organization supplies export insurance and credit. Loans in foreign currencies, assistance to mitigate the trading capital problems of small enterprises and international credit lines for trade financing are examples of the services proposed. Political, commercial and insolvency risks are also covered.
Mexico	COMESEC (Compañia Mexicana de Seguros de Crédito S.A.) Bancomext (a public financial institution)	COMESEC is a private company which offers domestic and export credit insurance. Bancomext, a government organization, has the mission of helping foreign trade by channelling credits, offering guarantees (against political risks and natural disasters) and promotional services. For its financial operations, it usually has recourse to the existing banking system.
Peru	SECREX (Compañía Peruana de Seguro de Crédito a la Exportación S.A.)	This company, which was established by the main banks and insurance companies, offers short-term insurance against commercial risks (bankruptcy and default to an extent of 80 per cent).
Trinidad and Tobago	EXICO (Export Credit Insurance Company)	This is a public institution which supplies export credit insurance (commercial and political risks) and an export-financing mechanism.
Uruguay	Banco de Seguros del Estado	This is a public institution which provides short-term coverage against commercial risks.
Venezuela	The Mundial (La Mundial Venezolana de Seguros de Crédito); ICE (Instituto de Comercio Exterior) and Finexpo (Fondo de Financiamento a las Exportaciones)	The Mundial proposes a coverage against commercial risks (and insolvency) linked to export activities (before and after dispatch). Insurance policies against political risks, extraordinary risks and the risk of cancellation of contract are offered by agreement with the public sector.
Hungary	HEG (Exportgarancia)	HEG offers insurance policies, direct credits and means of refinancing. The group's main activity is insurance against political risks. In order to use its services, a company must have a minimum proportion of 60 per cent Hungarian funding. Coverage is 85 to 90 per cent of the value of the transaction.
Cyprus	ECIS (Export Credit Insurance Services)	ECIS is a department of the Ministry of Trade and Industry. Insurance covering about 90 per cent of losses is proposed, exporters having consequently to put on one side part of their profits.
Iran	EGFI (Export Guarantee Fund of Iran) and EIIC (Export Investment Insurance)	Under the auspices of the Ministry of Trade, EGFI offers guarantees to local exporters against commercial and political risks. EIIC proposes a credit insurance policy and a financing mechanism for non-oil export products.
Israel	IFTRIC (Israel Foreign Trade Risks Insurance Corporation)	IFTRIC, a public institution, offers a credit insurance policy which includes short-, medium- and long-term coverage. Political, commercial and economic risks are underwritten.

Jordan	Arab Life and Accident Insurance Corp. and Jordan Loan Guarantee Corp.	The first of these corporations is private, the second public. They both offer short-term insurance cover against commercial risks.
Lebanon	CLPC (Compagnie Libanaise pour la Protection du Crédit)	CLPC has recently established a structure which proposes a short-term credit insurance against domestic and export risks.
Turkey	Turk Eximbank (Export Credit Bank of Turkey)	This official agency endeavours to improve export performance by offering credit-insurance (against commercial and political risks), guarantee and financing programmes.
Japan	EID (Export-Import Insurance Division)	EID is a division of MITI (Ministry of International Trade and Industry). It proposes a whole range of insurance policies from general coverage to "made to measure" contracts via exchange risks. Export financing is carried out by the Japanese commercial banks working closely with the Export-Import Bank of Japan.
Australia	EFIC (Export Finance and Insurance Corporation)	EFIC offers exporters an insurance against non-payment risks and a coverage against political risks. There is a possibility of granting loans to international counterparties wishing to acquire Australian goods and services.
New Zealand	EXGO (The Credit Insurance Unit of State Insurance Ltd.)	The EXGO credit insurance unit is a member of the Norwich Union Insurance Group of the United Kingdom. EXGO can cover every type of export contract but the bulk of its operations are concentrated on the short term and the primary sector.
Bangladesh	ECGD (Export Credit Guarantee Department of the Sadharan Bima Corp.)	There are insurance policies for operations before and after dispatch, commercial risks are covered to the extent of 85 per cent and political risks to 95 per cent.
China	China Eximbank (Export-Import Bank of China)	This institution, which operates principally in financing, is supposed also to offer export and import credit insurance and factoring services.
Korea (Republic of)	Keximbank (The Export-Import Bank of Korea)	This government institution offers loans to both purchasers and suppliers, support to international financial institutions and guarantees.
India	I-Eximbank (Export-Import Bank of India) and ECGC (Export Corporation of India)	I-Eximbank finances the exports of manufactured goods, computer equipment, consultation services and export-oriented construction and other projects (even joint ventures). ECGC offers export protection against commercial and political risks for the short term and the long term.
Indonesia	ASEI (Asuransi Ekspor Indonesia)	ASEI, a government agency, proposes guarantees for export credits, credit insurance and investment abroad as well as commercial information. In addition to commercial and political risks, the insurance policies cover the risk of non-payment for goods and services and guarantees on behalf of the banks.

Malaysia	MECIB (Malaysia Export Credit Insurance)	MECIB, owned by the main private banks, offers credit insurance and other guarantees for the financing of exports and investments.
Pakistan	Pakistan Insurance Corporation	Although private, this institution is under government control. It offers guarantees covering commercial risks up to two thirds of losses before dispatch and 80 per cent after. Political risks are also covered, to an extent of 90 per cent.
Philippines	Philguarantee (Philippine Export and Foreign Loan Guarantee Corporation)	This public financial organization offers guarantees against export financing risks (before and after dispatch)
Singapore	ECICS Credit Insurance Ltd. - ECICS Holdings Ltd.	ECICS offers credit-insurance policies. The Monetary Authority's rediscount programme grants short-term financing to exporters.
Sri Lanka	SLECIC (Sri Lanka Export Credit Insurance Corporation), under the Ministry of Trade	SLECIC proposes insurance policies for exporters of goods and services against payment delays caused by commercial and political incidents. Guarantees are also offered to banks and other national or international financial institutions to facilitate the financing of Sri Lankan exports before and after dispatch.
Taiwan, Chinese Province of	T-Eximbank (The Export-Import Bank)	"The Export-Import Bank of the Republic of China" proposes six different insurance policies covering commercial and political risks.
Thailand	The Export-Import Bank of Thailand	This government institution offers various commercial and financial services such as, for instance, an export insurance policy or participation in a Thai capital investment abroad. Since 1994, an export credit insurance system has been offering coverage against commercial and political risks.
Algeria	CAGEX (Compagnie Algérienne d'Assurance et de Garantie des Exportations)	CAGEX is a newly-established government institution which ensures protection against commercial and political risks.
Egypt	Export Credit Guarantee of Egypt	Established on the initiative of the Egyptian Export Development Bank, it is a private company supplying short-term coverage of commercial risks.
Morocco	SMAEX (Société Marocaine d'Assurances à l'Exportation)	A semi-public company (the chief shareholders are the State to an extent of one third and banks and insurance companies for the rest), SMAEX underwrites commercial risks in transactions with the European Union and commercial and political risks for operations with Eastern Europe and sub-Saharan Africa.
Nigeria	NEXIM (Nigeria Export-Import Bank)	This institution, under the auspices of the Federal Government, has not yet become really operational.

Mauritius	DBM (The Development Bank of Mauritius)	The export credit and insurance programme of the DBM guarantees the exporters, thus enabling them to obtain bank loans for their pre-dispatch operations. The non-repayment risk (if the exporter is not paid) is thus covered by DBM.
Senegal	ASACE (Agence Sénégalaise d'Assurance pour le Commerce Extérieur)	ASACE, a government agency (which is to be privatized shortly), offers a credit-insurance policy for exporters together with information concerning the activities of their competitors. The risks covered are political and/or commercial.
South Africa	Credit Guarantee Insurance Corporation of Africa	Export credits do not constitute a favourite area for South Africa. However, there is a private insurance scheme which covers, in addition to domestic and export risks, the risk of non-repayment of a debt made out in the national currency. Political risks are underwritten in cooperation with the Government.
Zimbabwe	RBZ (Reserve Bank of Zimbabwe) and Credsure (Credit Insurance Zimbabwe Ltd.)	RBZ, a department of the Central Bank, controls export credits. Credsure is a private company which offers domestic and export credit-insurance policies for both commercial and political risks.

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Annex II

PRINCIPAL MEANS OF PAYMENT

		Main advantages	Main drawbacks
Simple collection	**Cheque**: a written document committing a purchaser (the drawer), a banking establishment (the drawee) and a seller (the payee)	• free of charge (in international operations, however, the "under reserve" clause is often used by the payee's bank against the payment of agios); • endorsement possible; • simple	• difficult (or impossible) to use in some countries (United States); • possibility of insufficient funds (except in the case of a certified cheque or banker's draft); • risk of loss, theft, forgery, etc.
Promissory notes and bills of exchange (they are also called commercial bills or paper)	**Bank transfer**: this is a mode of electronic payment without paper backing. The SWIFT[1] system, based on EDI[2], is the most usual one if the country concerned is connected to the network (more than 60 countries and about 2000 banks)	• inexpensive • no risk of loss, theft, forgery, etc. • no possibility of dishonour	• issued on the buyer's initiative • slowness • no possibility of endorsement
	Bill of exchange or draft: a written document in which the buyer (the drawee) is required to pay a certain sum to the seller (the drawer) or to a third person.	• issued on the initiative of the seller who fixes the date of payment • limits the exchange risk • endorsement possible	• risk of dishonour (unless there is a bank aval). • risk of loss, theft, forgery, etc.
	Promissory note: a written document in which the buyer (the drawer) promises his creditor (the payee) to pay, on presentation of the note, a certain sum of money to a specified bank (and on a given date).	• mobilizable • endorsable	• counterpart risk (dishonour) • exchange risk • risk of loss, theft, forgery, etc. • issued on the buyer's initiative, hence possibility of changing the amount or the due date.

Documentary collection	**Presentation of (or collection against) documents**: the seller (the originating party) hands the operation over to his bank (the remitting bank), which establishes the documents (transport documents, invoice) on his behalf. The bank then (through the intermediary of a presenting bank) proceeds to the collection (payment or acceptance of the draft) against presentation of the documents to the buyer.	• simple • rapid • commercial • relatively cheap	• major risk for the seller - little security (counterpart risk) • country risk • logistics risk (if the goods are refused at the destination)
	Documents against payment: a written notation on the draft binding the carrier (or an agent) to hand over the goods only against payment by the consignee (thus no bank is involved)	• flexibility • simplicity • no red tape • logistics advantage (a qualified carrier who bears the risk)	• expensive (the premium charged by the carrier who bears the risk is relatively high) • limited • source of complications if the consignee refuses delivery
	Documentary credit: "a tripartite relationship made up of the seller, the buyer and the buyer's bank" (Source: Caisse Nationale de Crédit Agricole). There is not, however, just one documentary credit but three, and several ways of making them out. Hence there is a multitude of combinations.	• cancels the counterpart risk if the documentary credit is irrevocable and the political risk if it is irrevocable and confirmed	• terminology must be appropriate and accurate (beware of errors) • relatively expensive

The principal methods of payment are recorded above in a non-exhaustive way. They are classified from the most risky, i.e. simple collection systems (cheques, bank transfers and commercial paper - bills of exchange and promissory notes)[3] to documentary collection systems (presentation of documents, documents against payment and documentary credits). However, when we consider the marketing of commodities in the developing countries, the documentary credit will often be the instrument offering the greatest security of payment, an essential factor in the light of the various currents of economic liberalization and globalization or, in other words, the emergence

Annex III

PARTICIPATION OF THE DEVELOPING COUNTRIES IN INTERNATIONAL ARBITRATION

Table 1

Participation in ICC arbitration[1] in 1993

Countries	Participation rate (% age)
Sub-Saharan Africa	4.4 (if Ethiopia is excluded, then 2.6)
North Africa	3.0
Latin America and the Caribbean	3.1
North America	11.9
South and South-East Asia	6.3
Central and Eastern Europe	5.8
Northern Europe	60.7
Middle East	4.1
Oceania 900	0.7

Source: *The ICC International Court of Arbitration Bulletin*, vol. 5/N.1 - May 1994

Table 2

Evolution of the rate of participation of the sub-Saharan African countries in ICC arbitration

Year	Participation (% age)	Year	Participation (% age)
1977	5.00	1987	4.00
1978	4.00	1988	5.50
1979	5.00	1989	5.50
1980	1.72	1990	2.20
1982	2.00	1991	2.10
1983	3.10	1992	2.60
1984	3.00	1993	4.40
1985	4.20	1994	2.60
1986	3.20	1995	1.90

Source: "International Commercial Arbitration in Sub-Saharan Africa: Law and Practice", *The ICC International Court of Arbitration Bulletin*, vol. 7/N.1 - May 1996.

Annex IV

EURIBOR, A REFERENCE POINT FOR THE FUTURE EURO AREA

In addition to LIBOR, which serves generally as a reference interbank rate, the other European countries also have their own local interbank rates: PIBOR, FIBOR, BIBOR, etc. A number of domestic banks participate in the composition of a reference rate in each of the various countries of the European Union.

In the context of European monetary unification and in the light of the inauguration of a unified exchange and rate policy vested in the European Central Bank, it is planned to set up a common interbank rate, Euribor[1], on 4 January 1999. With the advent of the euro, the market will need a reference both to facilitate commercial and financial transactions and to make certain forward covering operations possible. The construction of the Euribor index seems to be the solution to this problem.

Table 1

Domestic interbank rates of some countries on the continent of Europe

Rate	Place	Currency of quotation
AIBOR	Amsterdam	Netherlands guilder
ATHIBOR	Athens	Drachma
BIBOR	Brussels	Belgian franc
CIBOR	Copenhagen	Danish krone
DIBOR	Dublin	Irish pound
FIBOR	Frankfurt	deutsche mark
HELIBOR	Helsinki	markka
LISBOR	Lisbon	Portuguese escudo
LIBOR	London	pound sterling
LUXIBOR	Luxembourg	Luxembourg franc
MIBOR	Madrid	peseta
PIBOR	Paris	French franc
RIBOR	Rome	lira
STIBOR	Stockholm	Swedish krona
VIBOR	Vienna	schilling

Sources: MATIF; *Eurotimes*, quarterly 1997, No. 3

Annex V

COMPETITIVENESS AND FREIGHT RATES[1]

The magnitude of transport costs in some developing countries constitutes a significant barrier to the trade in commodities. In 1990/91 , for example, net freight and insurance costs for Africa were US $3.9 billion, or almost 15 per cent of the value of the region's exports.[2] Moreover, a certain heterogeneity is noticeable: if net freight and insurance costs represent between 25 and 30 per cent of exports in the countries of sub-Saharan Africa as a group, they can amount to more than 70 per cent in Somalia or in Uganda. For the landlocked African countries of Burkina Faso, Central African Republic, Chad, Ethiopia, Malawi, Mali, Niger, Uganda, Zambia and Zimbabwe, this figure is on average close to 42 per cent. A high proportion of export earnings is thus paid out to ensure transport services.

Table 1

Freight costs in sub-Saharan Africa for exports to the United States in 1993

Transport mode	Distribution of nominal freight costs				Δ freight rates sub-Saharan Africa/competitor (in %)	
	Quartiles					
	First quartile	Median value	Third quartile	Divergence between the extreme values	Medium value	Divergence between the extreme values
Air	5.3	14.1	26.5	0.5 to 87.4	3.5	-13.9 to 71.2
Sea	4.6	7.5	13.8	0.2 to 56.1	2.1	-5.8 to 39.9

Sources: United States Department of Commerce; *Finance and Development*, December 1996

The data concerning nominal freight rates (the ratio of transport and insurance costs to the value of exports) also constitute an important source of information on the impact of these costs on African trade. Many countries collect data on international transport operations and the cost of import insurance policies. The table above summarizes, for example, the statistical data on transport and insurance costs for non-oil exports from sub-Saharan Africa to the United States. In this table, the nominal freight rates are presented per quartile together with the difference between the freight rates for exports from sub-Saharan Africa and those of its competitors (the positive values mean that the transport costs are higher in sub-Saharan Africa). As a group, the countries of sub-Saharan Africa are faced with heavy transport costs, which result in a considerable loss of competitiveness vis-à-vis their commercial rivals. On one occasion in every two, maritime freight rates are more than two per cent higher than those paid by their direct competitors for the same product.[3] The third quartile indicates that one quarter of the exports from sub-Saharan Africa are transported (by sea) at a freight rate 13.8 per cent higher than that of their immediate competitors. What is more, these statistics do not include the data for inland transport (which is very costly for the landlocked developing countries).

In addition to its direct effect upon competitiveness, this phenomenon has an impact on the type of goods exported. Nominal freight costs in these countries are, in fact, often relatively higher for processed commodities (cocoa powder or cocoa butter) than for the raw primary commodities (cacao beans).[4]

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